‘COLD REALITY IN THE LAND OF FIRE:’ THE INTERRELATIONS OF AZERBAIJAN’S NATURAL GAS EXPORT AND FOREIGN POLICY

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ABSTRACT

CSABA MAROSVARI: 'Cold Reality in the Land of Fire:' The Interrelations of Azerbaijan's Natural Gas Export and Foreign Policy
(Under the direction of David N. McNelis)

Azerbaijan, a landlocked post-Soviet country since its independence has been trying to utilize its energy resources in its foreign policy. With production-sharing agreements with Western oil companies beginning with the 1994 signing of the "Contract of the Century" and the construction of the Baku-Tbilisi-Ceyhan oil pipeline Azerbaijan successfully opened up its energy sector for foreign investment and used pipelines to stabilize its economy and underpin its foreign policy. The discovery of the Shah Deniz gas field opened up new opportunities for Baku to buttress its foreign policy goals with the export of natural gas. In this Master's thesis I will evaluate and show the importance and significance of natural gas export in Azerbaijani foreign policy.

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ABBREVIATIONS

ACG – Azeri-Chirag-Guneshli oil fields

AGP – Arab Gas Pipeline

AGRI – Azerbaijan-Georgia-Romania Interconnector

AIOC – Azerbaijan International Operating Company

BTC – Baku-Tbilisi-Ceyhan oil pipeline

BTE – Baku-Tbilisi-Erzurum gas pipeline

CIS – Commonwealth of Independent States

CSTO - Collective Security Treaty Organization

ITGI – Interconnector Turkey-Greece-Italy

LNG – liquefied natural gas

PSA – production-sharing agreement

SEEP - South-East Europe (gas) Pipeline

SOCAR – State Oil Company of Azerbaijan Republic

SOFAZ – State Oil Fund of Azerbaijan

TAP – Trans-Adriatic (gas) Pipeline

TCP – Trans-Caspian (gas) Pipeline project

INTRODUCTION

Energy and energy issues have emerged as some of the most important aspects of security studies. The growth of energy consumption, especially in the developing economies of China and India since 2000, drove up oil prices and caused pricey investments in pipelines and liquefied natural gas (LNG) terminals all over the world. Although the economic crisis of 2008–2009 had a short-term downturn effect on the world's energy consumption,[1] this seems to have been only a temporary phenomenon. Growth in demand is projected worldwide for several decades to come, despite the recent crisis.

Natural gas has attracted major attention within the discussion of the future of energy production, not only because it is a cleaner source of energy than oil or coal[2] (emitting almost 30 percent less carbon dioxide than oil and just under 45 percent less carbon dioxide than coal) but also because of its widely dispersed global locations. Thanks to the prospect of wider utilization of unconventional gas, despite environmental concerns about hydraulic fracturing technology, it is a relatively flexible, abundant resource for the expectedly booming international gas demand.[3] The effects of the Fukushima disaster of March 2011 include

[1] *Enerdata* (2011) *Global Energy Statistical Yearbook 2011*.Source: http://yearbook.enerdata.net/. Retrieved: 16 January 2012.

[2] *NaturalGas.org*. http://www.naturalgas.org/environment/naturalgas.asp#greenhouse/. Retrieved: 7 November 2008.

[3] International Energy Agency (2011) *Are We Entering a Golden Age of Gas? World Energy Outlook 2011*. International Energy Agency, Paris.

increased demand for natural gas if interest in nuclear energy production declines.[4] The impact of the production of shale gas in the United States is a fact; however, whether the LNG oversupply to Europe will make future expensive pipeline projects commercially useless remains unclear.[5]

Transportation of natural gas continues to present technical and strategic challenges. Despite the expansion of LNG trade, gas remains a largely regionally bound energy resource because the biggest volumes of gas can be most readily transported through pipelines and the long-term storage of large volumes of natural gas is technically impossible. Although precise levels of demand, consumption data and prices cannot be foreseen, natural gas will remain a resource of strategic and political importance.

Within the strategic issues of energy trade, one of the most heated areas has been the Caspian region, a position clearly symbolized by the 2006 opening of the Baku-Tbilisi-Ceyhan oil pipeline that effectively broke Russia's oil transit pipeline monopoly in the post-Soviet region by carrying Azerbaijani oil through Georgia to Turkey.[6] Azerbaijan has also been a focus of the debates around Caspian natural gas resources and export.

A landlocked country since it gained independence upon the collapse of the Soviet Union in 1991, Azerbaijan was shattered by political and economic transitions, internal

[4] As a clear result of Fukushima, the federal government of Germany gave in to popular anti-nuclear feelings and decided to shut down all of Germany's nuclear facilities by 2022. *Kabinett beschließt Atomausstieg bis* 2022, *Die Zeit*, 6 June 2011. Source: Source: http://www.zeit.de/politik/deutschland/2011-06/atomausstieg-energiewende-gesetzespaket. Retrieved: 6 June 2011.

[5] Rogers HV, (2012) *The Impact of a Globalising Market on Future European Gas Supply and Pricing: The Importance of Asian Demand and North American Supply*, Oxford Institute for Energy Studies, Oxford.

[6] Deák AG (2008) *Az EU-n kívüli térségekbe irányuló orosz szénhidrogén-export perspektívái* [The Perspectives of Russian Hydrocarbon Exports to non-EU Regions]. In: Novák T (ed.) *Kelet-Európa tanulmányok III.* Budapest: Magyar Tudományos AkadémiaVilággazdasági Kutatóintézete, 207.

political turmoil and the 1988–94 war with Armenia over Nagorno-Karabakh.[7] Azerbaijan has been trying to utilize its energy resources to strengthen its political independence and create a basis for the development of its economy. With the 1994 signing of what was called "the Contract of the Century," the first production-sharing agreement (PSA) with foreign (mostly Western) companies on the Azeri-Chirag-Guneshli (ACG) oil fields, Azerbaijan successfully opened up its energy sector to foreign investors in order to stimulate its economy with hydrocarbon revenues. The growing number of investments and PSAs, and their implementation, led to a surge in Azerbaijani oil production with a windfall of oil revenues[8] that stabilized the internal economic and political order.

The "Contract of the Century" had also important regional strategic and security implications. Baku's negotiations with Western oil companies, which began as early as 1989, not only implied invitations to foreign capital and technology but also established the practical appearance of Western strategic interests in the Southern Caucasus. The independence of the former Soviet republics, the Nagorno-Karakakh conflict and the possibility of Azerbaijani oil export all made a serious impact upon the three key regional powers (Russia, Iran, and Turkey) as well as upon American policymaking. Russia, itself in turmoil at the time, tried to influence and control the political processes of the Southern Caucasus. Iran, a country with a significant Azeri minority, was afraid of Azerbaijani irredentism. Turkey was not only looking to Azerbaijani oil as a way to make itself an

[7] The Karabakh question continues to haunt the Azerbaijani government. The autonomous oblast of Nagorno-Karabakh, with its Armenian majority, was part of the Azerbaijani SSR in the Soviet era. Upon the collapse of the USSR the Armenian population agitated for independence; by 1992 the conflict had escalated into war. By 1994 Armenia occupied 16–18% of the area of Azerbaijan, including Nagorno-Karabakh, a situation that caused the flight of more than half a million Azeri refugees (IDPs). Although a ceasefire agreement was reached in May 1994, the Karabakh question is still a "frozen conflict" in this post-Soviet region.

[8] Oil revenues grew from 2.97 billion USD in 2006 to 22.7 billion USD in 2010. Ibadoglu, G (2011) *Azerbaijan's Economic Model and Its Development Since Independence*. Baku: Economic Research Center. Source: http://www.erc-az.org/new/uploads/file/eng1.pdf. Retrieved: 14 October 2011.

important energy transit hub but was also trying tried to widen its influence in the newly independent pos-Soviet Turkic republics. For its part, the United States wanted to strengthen its positions with the newly independent states in the Southern Caucasus.

Azerbaijan President Heydar Aliyev (1993–2003), cognizant of the geopolitical realities of Azerbaijan's landlocked location, led a pragmatic or multi-vectoral foreign policy based on the diversification of oil export. Multi-vectiralism, though lacking a generally accepted definition, is a widely used term both in media and academic sources to define the foreign policy strategy or behavior of especially post-Soviet countries (Ukraine, Kazakhstan, Azerbaijan, etc.) that have built strong relationship with other geopolitical actors in order to counterbalance Russia's influence and enhance their own independence.[9]

In partnership with Turkish and American incentives, Azerbaijan constructed the Baku-Tbilisi-Ceyhan (BTC) oil pipeline to export its growing oil output to world markets without passing through Russia or Iran. However, despite this partnership with Western companies, Baku cannot and has not completely turned its back on Moscow. Becasue Azerbaijan was compelled to use the Baku-Novorossiysk pipeline as a main route for export until the opening of the BTC pipeline, Russia controlled much of the Azerbaijani oil exports between 1996 and 2006. Russia was also the main source of Azerbaijani natural gas import until 2007; its alliance with Armenia means that it remains the key to resolving the Nagorno-Karabakh issue.

The PSAs that began with the "Contract of the Century" were also constructive in terms of natural gas. During the Soviet era, Azerbaijan had been compelled to import gas since the late 1980s. As a result of the discovery of the large Shah Deniz natural gas field in 1999

[9] Additional discussion on multi-vectoralism appears on pp. 29-31.

under the PSA operated by BP and Statoil, it became possible for Baku to become self-sufficient in natural gas. When Shah Deniz launched production in 2006, Azerbaijan managed to realize this goal. In addition, after the opening in 2007 of the Baku-Tbilisi-Erzurum (BTE) gas pipeline, which was constructed parallel to the BTC, Azerbaijan was not only able to suspend natural gas imports from Russia and become completely independent of Russian hydrocarbon supplies but also began to export natural gas to Georgia and Turkey. Especially after the Russo-Ukrainian gas crisis of 2006,[10] Azerbaijan was seen by the European Union as the keystone of its natural gas import diversification efforts in the Caspian region (later known as the European Southern Gas Corridor).

Azerbaijan was amenable to these European ambitions because the construction of pipelines to Europe fit its multi-vectoral foreign policy. The establishment of natural gas export to Europe would bring several benefits to Azerbaijan. First, it would mean a real diversification of natural gas export, similar to oil, which would lead to a breakout from the current regional infrastructural-geographical constraints of Azerbaijan's gas pipelines to Russia, Iran and Turkey (through Georgia). Second, in contrast to Iran, Russia or even Turkey, countries that have past[11] as well as future capabilities of direct interference, Europe may provide a far-reaching and well-paying[12] but politically not-too-interfering partner. Third,

[10] The 2006 gas crisis was a result of a long debate between Russia and Ukraine on the gas price hike for Ukraine by Gazprom as well as Ukraine's inability to pay and Russian allegiations of Gazprom gas stolen from Ukrainian storages. On January 1, 2006 Gazprom reduced pressure in pipelines to Ukraine that led to the cut of Russian gas supply through Ukraine to Europe.

[11] Cornell SE (2011) *Azerbaijan Since Independence*. New York: M.E. Sharpe, 70–87.

[12] Post-Soviet gas exporter states have long wished for "European" netback prices, although the prices of natural gas trade in the CIS were lower than the European prices. Moscow has been in control of the transit routes of gas from Central Asian producers (Turkmenistan and Uzbekistan) to other CIS countries and Europe, which has enabled Russia to procure gas cheaply and to re-export it to Europe for hard currency. Due to the economic crisis, however, many other CIS gas importers have also been unable to pay netback prices to exporters. Therefore, since the early 1990s the key strategic goal of post-Soviet gas exporters has been to reap "European" netback prices from their CIS partners. See: Miyamoto A (1998) *Natural Gas in Central Asia: Industries,*

European plans to import natural gas from Central Asia are set to transform Azerbaijan into a transit country of key strategic importance.

However, due in part to difficulties with the implementation of the European gas pipelines, Baku has also been looking to non-European markets to further diversify export.[13] Azerbaijan began to export natural gas to Russia in 2009 and in January 2011 signed a 5-year export contract with Iran. Azerbaijan also plans to export natural gas to Syria through Turkey and has begun negotiations on LNG exports to Ukraine through Georgia.

1. Azerbaijan, a landlocked natural gas exporter

"Energy producers seek security of demand so that national budgets can anticipate a steady and predictable revenue flow," noted Gal Luft and Anne Korin (2009).[14] Substantial reserves of natural gas (particularly when some of them are intended for export) and a need for security of demand have two implications: geopolitical and commercial. Beyond the basic common understanding of geopolitics as the impact of geographical factors on policy making,

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Markets and Export Options of Kazakhstan, Turkmenistan and Uzbekistan. London: Royal Institute of International Affairs, 7.

[13] ten Hoedt R (2010). 'We do not want to depend only on one pipeline' Interview: Azerbaijani top negotiator Elshad Nassirov, *European Energy Review.* Source: http://www.europeanenergyreview.eu/site/pagina.php?id=2528. Retrieved: 15 November 2010.

[14] Luft G and Korin A (eds.) (2009) Introduction. In: Luft G and Korin A (eds.) *Energy Security Challenges for the 21st Century*. Santa Barbara: Praeger Security International, 9.

Joe Barnes et al. (2006) defined the geopolitics of gas as "not simply an endless jockeying for global position, but also the immensely political actions of governments, investors, and other key actors who decide which gas trade projects will be built, how the gains will be allocated and how the risks of dependence on international trading will be managed."[15] Regarding Caspian natural gas trade, the basic premises of geopolitics are still true. Because the technical difficulties of natural gas trade (pipeline and LNG) and the issue of transit countries are interrelated, geopolitical situations are important determinants for the formulation of natural gas trade of landlocked countries that, like Azerbaijan, have abundant gas resources.

Foreign policy also must contend with the constraints of geopolitics. As a newly independent, landlocked post-Soviet country endowed with not insignificant hydrocarbon resources and a largely energy revenue-dependent economy, Azerbaijan faced a complex problem stemming from its very location. Although Baku did gain independence from Russia, Azerbaijan's relations with Russia have remained complex. For example, Moscow supported Azerbaijan's adversary in the Nagorno-Karabakh conflict, sought to restore its influence in the Southern Caucasus, intervened in Azerbaijani domestic politics in the early 1990s, was the source of import of natural gas and controlled all of the transit routes for Azerbaijani oil. In response, Azerbaijani leadership has been compelled to seek a breakout from their country's geographically landlocked situation in order to strengthen the country's independence, even as they have formulated the rest of their foreign policies.

Azerbaijan has used the diversification of oil export routes, with the involvement of Western companies, to emphasize its independence and create a basis for its development

[15] Barnes J et al. (2006). Introduction. In: Victor DG, Jaffe M and Hayes MH (eds.) *Natural Gas and Geopolitics: From 1970 to 2040*. Cambridge: Cambridge University Press, 5.

through oil revenues. Given the even bigger challenges posed by technical hurdles and the need to consider the strategic value of transit infrastructure, natural gas may turn out to be a useful instrument for Baku to strengthen its regional positions against its powerful neighbors. It will be particularly useful if Russia and Iran counter these efforts by "bringing" the European Union to the Southern Caucasus through pipeline connections, diversifying further to the Middle East (and, possibly, Ukraine). Even so, Azerbaijan has the valuable option of becoming a transit country for Central Asian natural gas.

The direct connection of infrastructure would not mean active leverage or involvement of partners in the region. Instead, a direct connection would more passively confer leverage upon Baku if a regional event threatens the security of energy transport between Azerbaijan and its markets (primarily Europe). The geopolitical implications are clear, given the fact that Azerbaijan is a landlocked country that must build pipelines to its markets through transit states. These implications, although they seem evident, are also too determinative.

Commercial implications mean the financially measurable gains and losses from natural gas production and export. These, at first glance, do not seem to be as obvious as the geopolitical implications. In 2009, Azerbaijan's export revenues from natural gas had a marginal share of all exports, 1 percent, compared to oil revenue's 92 percent share.[16] However, Azerbaijan's oil output is expected to near its peak before 2015.[17] Because of key structural problems in the economy that stem from overdependence upon oil,[18] Baku is

[16] *Statistical Yearbook of Azerbaijan 2010*. 2010,Baku: State Statistical Committee of Azerbaijan, 639–651.

[17] Centre for Global Energy Studies (21 July 2011). Azerbaijan's oil output begins to slip. Source: http://www.cges.co.uk/resources/articles/2011/07/13/azerbaijan%E2%80%99s-oil-output-begins-to-slip. Retrieved: 19 January 2011.

[18] Ibadoglu, G (2011). *Azerbaijan's Economic Model and Its Development Since Independence*. Baku: Economic Research Center. Source: http://www.erc-az.org/new/uploads/file/eng1.pdf. Retrieved: 14 October 2011.

motivated to find a new strategic commodity to sell and thereby to gain a new source of export revenues. By 2035,[19] Azerbaijan's export potential is estimated at 35 billion m^3 annually; an estimate that reveals the growing importance of natural gas to the country's economy. Nonetheless, whether natural gas really has the relatively marginal role it seems to have now, and whether the diversification of natural gas export is a geopolitical strategy-driven measure, are not known. The role that future natural gas exports will play in Azerbaijan's foreign policy has yet to be determined as well. Nor is it known whether Azerbaijan, despite its multi-vectoral approach, still looks to Europe as a primary market for its natural gas export. The the purely commercial reasons for Baku to expedite natural export in the near future also have yet to be discovered.

In this thesis I will evaluate and show the importance and significance of natural gas export to Azerbaijani foreign policy. My hypothesis is that, due to strategic reasons embedded in its multi-vectoral foreign policy, Baku intends to use the diversification of natural gas export in a similar way as it did with oil. However, natural gas export, due to its infrastructural restrictions, may have much more direct strategic security implications than oil export has had. Although Baku is pursuing a multi-vectoral foreign policy, given the constraints of its regional geopolitical situation, in the long term Baku will move closer to a well-paying, less interventionist partner like the European Union rather than closer neighbors that have historically been interventional. Mutual interest in natural gas trade between

[19] International Energy Agency (15 March 2011). Caspian oil and gas exports are poised for take-off. Source: http://www.iea.org/index_info.asp?id=1881. Retrieved: 13 June 2011.

Azerbaijan and the European Union gives Baku leverage and increases its (geo)political value, especially with the transit option of Central Asian natural gas.

However, the commercial importance of natural gas in the form of additional revenues is also an important factor. Not only are foreign investors expecting profit, but the oil-dependent Azerbaijani economy may also need new sources of income to mitigate the decline of oil revenues. In addition, even if Azerbaijan does look for other natural gas markets in the future, the establishment of European gas trade (which entails a closer relationship with an extra-regional, non-interfering mentor) remains of primary importance.

I argue that although the strategic, geopolitical reasons behind Azerbaijani export projects (especially to Europe) seem to play a primary role, yet commercial reasons have the same importance given the considerable income energy export means for the Azerbaijani economy. Multi-vectoral foreign policy, with its strategic implications underpinned by energy export policy, serves also a commercially successful energy export strategy that underpins foreign policy goals, so basically energy export-related foreign policy in Azerbaijan in many ways also means foreign economic policy as foreign policy strategy and commercial interestss in energy export are actually hard to distinguish from each other. Even if natural gas may not be as commercially significant to Azerbaijan as oil has been, its overall importance should not be underestimated. In contrast to the diversification of oil export, however, the issue of natural gas export in Azerbaijani foreign policy has rarely been discussed by scholars. In this thesis I take a closer look at the role natural gas export may play in Azerbaijan's foreign policy strategy by applying the model of Azerbaijani oil export diversification and its role in the foreign policy to natural gas export diversification and its foreign policy implications.

Chapter 1 contains my methodological approach to the evaluation of the role of natural gas in Azerbaijani foreign policy. Chapter 2 examines the Azerbaijani oil export diversification strategy and its foreign policy implications, especially within the multi-vectoral foreign policy Azerbaijan has pursued since 1993. Chapter 3 includes an analysis of whether and to what extent strategic interests in the utilization of Azerbaijani natural gas export are analogous to strategic interests in the utilization of oil export in the 1990s. Chapter 4 considers the connections and decision-making system of Azerbaijani foreign policy and energy policy making, as well as the role of natural gas in Azerbaijani energy policy. Finally, Chapter 5 traces the international implications of Azerbaijani natural gas export.

CHAPTER 1

DISCUSSION OF THE ACADEMIC LITERATURE

The ultimate goal of this project is the evaluation of the importance and significance of natural gas export within Azerbaijani foreign policy. Foreign investment and the diversification of oil export have played key roles in Azerbaijan's foreign policy since 1991. Undoubtedly the beginning of negotiations with foreign oil companies in 1989, the "Contract of the Century" in 1994, the growing oil production and the diversification of oil export, especially the construction of the Baku-Tbilisi-Ceyhan oil pipeline, have played a crucial role in Azerbaijan's foreign policy. The surge in oil revenues that resulted from the growing oil production and export and the fortuitous coincidence of oil price hikes in the 2000s not only stabilized Azerbaijan's international and regional positions, but also, having flooded the state budget with petrodollars, stabilized the internal political and economic order. The "Contract of the Century" and the role of oil export diversification in Azerbaijan's multi-vectoral foreign policy strategy have been widely discussed in the academic literature.

Despite the fact that many observers of Azerbaijan still consider natural gas to be less significant than oil, this thesis is based on the hypothesis that, with its geopolitical and commercial implications, natural gas is of much greater importance for Baku's future foreign policy making than is now acknowledged. Therefore, herein I examine whether the model of oil export diversification in Azerbaijan's foreign policy may be applicable to Azerbaijan's

natural gas export strategy, and if so, what common implications and differences can be noted.

Azerbaijan is bordered by the Caspian Sea to its east and by Russia, Iran, Georgia, Turkey and Armenia. As Brenda Shaffer (2009) observed, [20] six permanent factors have influenced the foreign policies of Azerbaijan since the Azerbaijan Democratic Republic declared its independence from the former Soviet Union in 1918 (on roughly the same territory as the current Republic of Azerbaijan). First is the country's landlocked geographical location, which creates obstacles in foreign trade and presents challenges to the formation of foreign policy toward neighboring countries. Second is Azerbaijan's strategic location between Europe and Asia and its energy riches. Third is Azerbaijan's small size compared to its three major regional power neighbors (Russia, Turkey and Iran). Fourth is Azerbaijan's role as a major oil and gas exporter and the foreign policy opportunities and constraints that accompany it. Fifth is the contested borders between the states of the Caucasus. Sixth is the fact that the majority of the Azerbaijani ethnic group lives primarily in Iran.[21]

These six factors all include geographical aspects such as location, neighbors, and resources. Lack of ocean access and energy resources are also highly relevant, as Avinoam Idnan and Brenda Shaffer (2011) noted.[22] Landlocked states have much less maneuverability and narrower policy spheres, which in turn affect their foreign policy decisions. Energy exporters, which are additionally burdened by the issues of energy transit, attempt to establish

[20] Shaffer B (2009) Permanent Factors in Azerbaijan's Foreign Policy. In: Ismailzade F and Petersen A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 68.

[21] Shaffer B (2009) Permanent Factors in Azerbaijan's Foreign Policy. In: Ismailzade F and Petersen A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 69.

[22] Idnan A and Shaffer B (2011). The Foreign Policies of Post-Soviet Landlocked States. *Post-Soviet Affairs*, 27(3): 243–247.

a multi-directional or multi-vectoral foreign policy. Azerbaijan's multi-vectoral approach is indicated in three areas of its foreign policy: the establishment of multiple oil export pipelines and the creation of distinctive approaches to transit states and transportation issues.[23]

Energy and energy transport have been of paramount strategic importance for Azerbaijan. In the words of Deputy Foreign Minister Mahmud Mammadguliyev (2009), these factors represent the backbone of the country's national development.[24] Azerbaijan has utilized its energy resources to rebuild and develop its economy as well as to stabilize its internal stability and political independence. One of the key objectives of Azerbaijan's foreign economic policy is to ensure that Azerbaijan is an important and active participant in the new international energy security architecture. The development of transport infrastructure is considered a priority of Azerbaijan's national development strategy, especially because of its potential to link Central Asia and Europe.[25]

As Indra Overland stated, cooperation with the West may be important for Caspian energy producers from many aspects. For example, meetings with Western diplomats and leaders can raise the domestic legitimacy of Caspian leaders and their countries' international profile; for its part, the West can provide a relatively stable energy market as well as capital technology and organizational skills.[26] Although the awareness of the West about democracy in the Caspian region may sometimes become an irritant, the history of democracy in the

[23] Idnan A and Shaffer B (2011). The Foreign Policies of Post-Soviet Landlocked States. *Post-Soviet Affairs*, 27(3): 243–247.

[24] Mammadguliyev M (2009). Azerbaijan's Foreign Economic Relations. In: Ismailade F and Peterson A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 199– 215.

[25] Mammadguliyev M (2009). Azerbaijan's Foreign Economic Relations. In: Ismailzade F and Peterson A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 215.

[26] Overland I, Kjaernet H and Kendall-Taylor A (2009) Introduction: The resource curse and authoritarianism in the Caspian. In: Overland I, Kjaernet H and Kendall-Taylor A (eds.) *Caspian Energy Politics*. London: Routledge, 6.

region shows that realist geopolitical, strategic interests have easily overwritten its ideals.[27] Russia's own realist attitudes about non-democratic domestic political life and geographical proximity, as well as its need for cooperation from its neighbors and partners, is a basic reality for Caspian energy exporters such as Azerbaijan. Moscow, seeking to gain influence, "may be too close for comfort."[28]

Azerbaijan has used its oil resources to strengthen its independence, especially from Russia. As Adam Stulberg noted, although Russia has been trying to utilize its energy resources and control over the transit infrastructures of other post-Soviet countries' energy exports, Azerbaijan's oil expoert strategy went beyond market and utility maximization. Political-strategic motives, more than commercial interests when oil prices were low, caused Azerbaijani leadership to back the BTC pipeline (as a popular slogan of the 1990s phrased it, "Happiness is multiple pipelines"). It was strategically both logical and desirable for Baku to support the BTC, a decision strongly backed by the United States that meant independence from the Russian transit system.[29]

The first task of this thesis is to analyze Azerbaijan as a landlocked post-Soviet energy producer. Geopolitics, as the expression of relationships among foreign policy, political

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[27] See for example, the case of the United States. Veliyev J (2011). U.S. Foreign Policy Toward Azerbaijan, *The Washington Review of Turkish and Eurasian Affairs*, October 2011. Available at:, http://www.thewashingtonreview.org/articles/us-foreign-policy-toward-azerbaijan.html (retrieved: 15 January 2012). The modest reactions of EU officials also emphasize this reality. For background about the 2008 presidential elections, see *Declaration by the Presidency on behalf of the European Union concerning the presidential elections in Azerbaijan* (October 15 2008). Available from: Euractiv.com http://pr.euractiv.com/node/6312?page=6 (retrieved: 30 January 2012). For background about the 2010 Milli Majlis elections, see *Azerbaijan: Statement by EU HR Ashton on Parliamentary elections* (November 8 2011). Available from: http://www.eu-un.europa.eu/articles/fr/article_10341_fr.htm (retrieved: 30 January 2012).

[28] Overland I, Kjaernet H and Kendall-Taylor A (2009) Introduction: The resource curse and authoritarianism in the Caspian. In: *Caspian Energy Politics*, Overland I, Kjaernet H and Kendall-Taylor A (eds.). London: Routledge, 7.

[29] Stulberg A (2007). *Well-Oiled Diplomacy: Strategic Manipulation and Russia's Energy Statecraft in Eurasia*. New York: State University of New York Press, 138–155.

power and the physical environment, has been considered to be a useful framework through which to examine energy security and policy making, particularly as the location of energy resources and transportation issues impact interested states' foreign policies.[30] The following chapters examine more specific questions. Chapter 2 considers how Azerbaijan has used its oil resources in its geographically constrained location, the meaning of Azerbaijani multi-vectoral foreign policy, how Azerbaijan's positions change after signing "the Contract of the Century" in 1994, and how the growing production of oil and the growth of oil revenues in Azerbaijan transformed the geopolitical picture of the Caspian region. In Chapter 3, I discuss how natural gas might be of similar strategic value for Azerbaijan as oil has been.

Geographical location and geographically defined policy choices are only one side of the issue, however. As such they are relevant to the ways that mostly external, physical factors affect strategies, choices and decisions. Beyond the undeniable impacts of external factors upon natural gas export, which are certainly important because markets, transit routes, infrastructure, security and financing have to be taken into account, we must also examine how and in what way the decisions of Azerbaijani political leaders are made. As Güner Özkan (2006) stated, even though Azerbaijani policy makers have been aware of the foreign political usefulness of energy resources since independence, the development of energy resources by multinational oil companies cannot be divorced from internal issues and especially not from internal security issues.[31]

[30] Winrow GM (2007). Geopolitics and Energy Security in the Wider Black Sea Region. *Southeast European and Black Sea Studies*, 7(2): 1–2.

[31] Özkan G (2006) Economic and security values of Caspian energy for Azerbaijan. *Review of International Law and Politics* [*Uluslararası Hukuk ve Politika*], 6: 59–60.

In order to better understand the connections between natural gas and foreign policy, in Chapter 4 I will review the political economy of natural gas in Azerbaijan, for example where and how foreign policy and energy policy decisions (especially production-sharing agreements, export, etc.) are made, which players have decisive roles in making the decisions, how decisions have been made in oil and gas PSAs, and how infrastructure projects, especially gas pipeline projects, have been decided. I also discuss the role of natural gas in the Azerbaijani energy mix and expected revenue volume.

Energy issues and politics are so strongly interconnected as to be inseparable; as Shaffer observed, energy supply is an integral part of the foreign and national politics of states.[32] Energy for energy exporters and transit states alike is as much a part of their policy arsenals as other economic tools, military power and diplomatic relations. Infrastructure projects link states and also reflect the quality of their relations. Natural gas is not only the center of energy security policies, natural gas trade is more vulnerable than oil to political influence.[33] While the world oil market is well established, natural gas markets are still regionally fragmented (despite the expansion of LNG trade) because the delivery of gas is mostly bound to pipelines and to cross-border relations. This situation means that gas exporters, transit countries and markets are interdependent.

Furthermore, as Réka Szemerkényi (2007) also noted, within the strategy of energy exporter countries the utilization of the commercial advantages of energy export revenues is an instrument, not a goal; for these countries, energy policy is an "applied policy" for the

[32] Shaffer B (2009) *Energy Politics*. Philadelphia: University of Pennsylvania Press, 1–3.

[33] Shaffer B (2009) *Energy Politics*. Philadelphia: University of Pennsylvania Press, 1–3.

achievement of goals in other policy fields.[34] As Heidi Kjaernet (2010) described, energy plays a key role in the "economization of foreign policy." In other words, the utilization of energy sources serves as economic leverage for foreign policy goals (for example, how Russia has utilized energy as a leverage against many of its partners and how Azerbaijan has been trying to use it for its interests in the Southern Caucasus).[35]

In order to evaluate the significance of natural gas within Azerbaijani foreign policy, we must consider the international implications of Azerbaijani natural gas export, Azerbaijan's existing natural gas export markets (e.g., Russia, Georgia, Turkey and Iran), and its possible future export markets (the European Union, Syria, Jordan and Ukraine). This thesis analyzes the key meeting and sticking points of interest between Baku and Azerbaijan's current and possible natural gas trade partners, in order to explicate the basis for current Azerbaijani gas export, and a commodity for export, how natural gas trade relations came into existence and what role natural gas has played in these interstate relations.

The first places to look for answers are the current and potential transit countries. For landlocked Caspian energy exporting states, as Nikolai Dobronravin (2008) explained, the "transit curse" affects the development of all countries located between modern-day Russia and the southern border of the former Soviet Union. These countries aspire to bypass Russia and become the "window on Europe" because transit through Russia would significantly raise

[34] Szemerkényi R (2007) *Túlélő múlt? A hidegháború velünk élő energiabiztonsági tapasztalatai* [Surviving past? The accompanying energy security experiences of the Cold War]. *Magyar Külügyi Szemle*, 1: 34.

[35] Kjaernet H (2010) Azerbaijani-Russian relations and the economization of foreign policy. In: Overland I, Kjaernet H and Kendall-Taylor A (eds.) *Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan*. London: Routledge, 150.

the costs of oil or gas without any real profit for the producers.[36] However, as he also noted, the development of *inter alia* Azerbaijan depends as much (although not more) on the political and economic decisions of the transit countries as on similar decisions by the EU countries.[37] Transit is clearly one of the key issues in the implementation of Azerbaijan's gas export projects; an additional factor is that transit countries may also be consumers. Turkey's role is of particular importance given its potentially growing natural gas consumption and its location for the transit of Azerbaijani natural gas to Europe.

In evaluating the meeting and sticking points between the interests of Azerbaijan and its partners to establish the trade of natural gas, the pipeline projects that are debated and the energy aspects of interstate relations regarding future natural gas trade are salient issues. In order to fully understand these issues, we must ask what role natural gas plays in the economy of the current and future possible partners; why have these partners been or would they be interested in Azerbaijani natural gas; what is the method of transit; what strategic and financial implications are there regarding the implementation; and how have these implications affected/may affect Azerbaijan's positions.

Finally, we also have to acknowledge the possibility that Azerbaijan itself may become a transit country for Central Asian natural gas—a transit position that may be even more complicated if Azerbaijan also becomes a fellow supplier of natural gas (the same role to which Central Asian countries aspire). Although many issues surround the question of

[36] Добронравин НА (2008) Нефть, газ и «транспортное проклятие»: Казахстан, Туркменистан, Азербайджан. In: Добронравин НА and Маграния О (eds.) *Нефть, Газ, Модернизация Общества*. Saint Petersburg: Saint Petersburg State University Advanced School of Economics, 444–445.

[37] Добронравин НА (2008) Нефть. газ и «транспортное проклятие»: Казахстан, Туркменистан, Азербайджан. In: Добронравин НА and Маграния О (eds.) *Нефть, Газ, Модернизация Общества*. Saint Petersburg: Saint Petersburg State University Advanced School of Economics, 446.

Trans-Caspian gas trade and transit, given its implications for Azerbaijani relations with Turkmenistan in particular, possibility of this dual role must be examined.

If the geopolitical importance of building natural gas pipelines and foreign policy goals overlap the same way as they did in the case of oil export (as discussed in chapters 2–3), the commercial importance of natural gas may also have a central domestic political role (Chapter 4), particularly if real demand for Azerbaijani natural gas continues in Europe and other regions and the various transit and the infrastructural projects are both politically and commercially feasible (Chapter 5).

CHAPTER 2

AZERBAIJAN'S MULTI-VECTORAL FOREIGN POLICY AND THE DIVERSIFICATION OF OIL EXPORT

Azerbaijan historically has been an energy exporter. Half of the world's oil output was produced in Baku in the early 20th century.[38] Despite the gradual decline of production late in the Soviet era, Azerbaijan has been considered to be a country with potential opportunities for development.

Since declaring its independence upon the collapse of the Soviet Union in 1991, Azerbaijan has been trying to utilize its energy resources to strengthen its political independence; specifically, to create a basis for the development of its economy from hydrocarbon revenues. With the 1994 signing of "the Contract of the Century," the first production-sharing agreement (PSA) about the Azeri-Chirag-Guneshli (ACG) oil fields entered into with foreign (mostly Western) companies, Azerbaijan has successfully opened up its energy sector for foreign investors. President of Azerbaijan Heydar Aliyev (1993-2003) and his son and successor Ilham Aliyev (2003-) have led a multi-vectoral foreign policy that was primarily based on the diversification of oil export.

[38] Yusufzadeh, Kh (8 June 2011). Presentation at the 18th Caspian Oil and Gas Conference, Baku.

2.1. Azerbaijan's multi-vectoral foreign policy

Multi-vectoral, multi-directional, multi-dimensional, balanced or pragmatic are all terms that are widely used in official statements, as well as in academic literature and news articles, to define the foreign policy strategy or behavior of post-Soviet countries (Ukraine, Kazakhstan, Azerbaijan, etc.). An exact definition of "multi-vectoral," however, has not yet been reached.

To some degree, almost every country that maintans foreign relations with more than one other country employs a multi-vectoral foreign policy in the most basic sense: it has relations, or interactions, with countries other than itself. The term appears in common usage to address the very political stance of a country that is described by Idnan and Shaffer (2011) as to "refrain from joining exclusive alliance systems and maintain cooperation with competing alliance systems."[39] By Ariel Cohen's (2008) definition, multi-vectoral means "bilateral relations with each geopolitical actor, and [the avoidance of] sacrificing one vector for the sake of the other."[40] Bhavna Dave (2007) describes countries with multi-vectoral foreign policy not as „attaching priority to a single country" but rather "geared at developing close partnerships with all of [their] neighbours and an active engagement in multilateral regional organisations." [41] These definitions contain notions of balance, cooperation, partnership and lack of exclusivity from or priority for one over another partner nation or other entity. For a country with the location and the size of Azerbaijan, multi-vectoral means

[39] Idnan A and Shaffer B (2011) The Foreign Policies of Post-Soviet Landlocked States. *Post-Soviet Affairs*, 27(3): 243.

[40] Cohen A (2008) *Kazakhstan: The Road to Independence: Energy Policy and the Birth of a Nation*, Washington, D.C.: Johns Hopkins Central Asia-Caucasus Institute Silk Road Studies Program, 250.

[41] Dave B (2007) The EU and Kazakhstan: Balancing economic cooperation and aiding democratic reforms in the Central Asian region. *CEPS Brief* no. 127. p. 3.

reactive, adaptive policy making as well as responding to the circumstances and the moves of powerful players beyond its borders.

These priorities also appear in Azerbaijan's National Security Concept statement (2007), whch emphasizes "the independence, territorial integrity and democratic development of the country, integration into the Euro-Atlantic area as the strategic choice, and multidimensional and balanced foreign policy." The document also stresses the importance of relations with its neighbors and the European Union and states that "close cooperation of the Republic of Azerbaijan with the European Union will contribute to the stability in the Caucasus and will promote the European values in the region."[42]

For landlocked energy producer countries, a multi-vectoral strategic orientation and multiple export pipelines are key components of foreign policy.[43] Therefore, energy and energy resources have been closely interconnected within Azerbaijani foreign policy. Not only has Azerbaijan been utilizing its energy resources to rebuild and develop its economy as well as stabilize its internal stability and political independence, the development of transport infrastructure is also considered to be a priority of national development strategy—especially because of Azerbaijan's potential to link Central Asia and Europe.[44]

After independence, during the short tenure of President Ayaz Mutallibov (1991–92) Azerbaijan maintained a pro-Moscow stance. During the first democratically elected government, that of President Abulfaz Elcibey and the Azerbaijani Popular Front (1992–93), a foreign policy line developed that was pro-Western and pro-Turkish but anti-Russian and

[42] National Security Concept of the Republic of Azerbaijan (23 May 2007). Source: http://merln.ndu.edu/whitepapers/Azerbaijan2007.pdf. Retrieved: 15 January 2012.

[43] Idnan A and Shaffer B (2011) The Foreign Policies of Post-Soviet Landlocked States. *Post-Soviet Affairs*, 27(3): 243–247.

[44] Mammadguliyev M (2009) Azerbaijan's Foreign Economic Relations. In: Ismailzade F and Petersen A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 199– 215.

anti-Iranian. Since the fall of Elcibey[45] and Heydar Aliyev's rise to power (1993), however, Azerbaijan has maintained a multi-vectoral foreign policy that is manifested in two major areas.

First was the implementation of the strategy of having fair relations with Russia, which has been the key ally of Armenia and thus the key to the settlement of the Nagorno-Karabakh issue. Maintaining access to Karabakh is vital because of its history as the main source of Azerbaijani natural gas import; given Azerbaijan's landlockedness, if Moscow controls Karabakh it also controls Azerbaijani energy transit. Second, following Elcibey's line, Western companies became involved in the development of the Azerbaijani energy industry and U.S.-backed oil export pipelines began to be constructed in order to break Russia's control over the transit routes of Azerbaijani oil export. Clearly, access to oil and the ability to transport it were central issues in Azerbaijan's early foreign policy strategy.

2.2. The diversification of oil in Azerbaijan's foreign policy[46]

In the wake of the economic collapse of Azerbaijan in 1991-95, which can be attributed to its post-Soviet transition and the Nagorno-Karabakh war,[47] the revitalization of

[45] Some observers blame Moscow's direct involvement for Elcibey's fall because, in 1992–93, Moscow increased its support of Armenian troops in the Karabakh war against Azerbaijan and also backed the renegade Azerbaijani paramilitary unit of Surat Huseynov. Cornell SE (2011) *Azerbaijan Since Independence*. New York: M.E. Sharpe, 70–77.

[46] In this section I partly utilize the research I have done on Caspian natural gas transit since late 2008, especially my conference paper titled Cold Reality in the 'Land of Fire' - Twenty years of geopolitical wrestling around Azerbaijani energy resources presented at the First CSEEES New Eurasia Conference at University of North Carolina at Chapel Hill (March 26 2011), at the 49th Southern Conference on Slavic Studies in Alexandria, VA (April 8, 2011) and at the 17th Annual REECAS Northwestern Conference at Washington University, Seattle (April 16, 2011). I published on the online journal of Institute of International Studies at the Corvinus University of Budapest *Grotius.hu*.: http://www.grotius.hu/doc/pub/YQMWRJ/2011_97_marosvari_cold_reality_.pdf.

the Azerbaijani economy and the stabilization of both its external independence and internal order have been of primary urgency. As a result, presidents Elcibey andAliyev both decided to open up its energy resources for foreign (mostly Western) investors.[48] In the opinions of Azerbaijan's strategy makers, foreign investment would not only bring essential capital and state of-the-art technology for the development of hard-to-approach offshore oil and natural gas fields, it would also give Baku leverage against its neighbors (especially Russia, which was reluctant to accept the independence of South Caucasus countries).[49]

On September 20, 1994, Baku signed the so-called "Contract of the Century," the first production-sharing agreement (PSA) with the Azerbaijani International Operating Company (AIOC), a consortium made up of 11 companies that were drilling the large Azeri, Chirag and Guneshli (ACG) offshore oil fields. Before 2000 this contract had been followed by 18 more PSAs.[50]

As the development of the ACG fields was expected to increase Azerbaijani oil output, it was crucial for Baku to arrange satisfactory transit for the country's oil export. Despite the participation of Lukoil in the "Contract of the Century," Russia tended to oppose[51] offshore

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[47] The Azerbaijani GDP fell by 58% between 1990 and 1995. International Energy Agency (1998) *Caspian oil and gas: The supply potential of Central Asia and Transcaucasia*. Brussels: Energy Charter Secretariat, Organisation for Economic Co-operation and Development, 153.

[48] The key distinction between Elcibey's and Aliyev's negotiations was that Aliyev, unlike Elcibey who wanted to avoid any Russian involvement in the Azerbaijani energy industry, brought in Lukoil in order to appease—and divide—at least part of the Russian elite. Özkan G (2006) Economic and security values of Caspian energy for Azerbaijan. *Review of International Law and Politics* [*Uluslararası Hukuk ve Politika*] 6: 67–69.

[49] Alekserov V (2009) Achieving Azerbaijan's strategic vision: Negotiating the "Contract of the Century." In: Ismailzade F and Petersen A (eds.) *Azerbaijan in Global Politics: Crafting Foreign Policy*. Baku: Azerbaijan Diplomatic Academy, 217–224.

[50] SOCAR Projects. Source: http://socar.az/44-projects-view-en.html. Downloaded: 2 February 2009.

[51] Lukoil Chairman Vagit Alekperov was of Azeri ethnicity and had close contacts with then Russian Prime Minister Viktor Chernomirdin, which led to a contradictory situation: the Russian prime minister and Energy Ministry did not oppose the "Contract of the Century," but the Ministry of Foreign Affairs did. Özkan G (2006)

Azerbaijani explorations in the Caspian. Moscow's disapproval and attempt to exert control over Azerbaijani energy transport was expressed in its proposal of what was at the time the only possible export route for Azeri oil: the existing Baku-Novorossiysk pipeline, which led to a deepwater harbor. In 1996 the Baku leadership agreed to export via that pipeline but was already searching for non-Russian export routes.[52]

Fearing irredentism in Baku, Iran (the southern neighbor with a vast Azeri minority) also viewed Azeri plans to tap oil and natural gas fields under the Caspian Sea with suspicion and moreover resented any Azerbaijani oil and gas exploration in the Caspian Sea because of unresolved border issues. Furthermore, Western involvement in the development of an Azerbaijani energy industry meant U.S. pressure to exclude not only Iranian firms from the projects but also Iran itself from accessing the transit pipelines.[53]

Beyond its cultivation of an exceptionally positive relationship with the Turkic-speaking Azerbaijan, Turkey also had interests in the Azerbaijani resources. These interests were based not only in Turkey's consideration of its own dependence on energy resources, but also in its interest in building an export pipeline that would transport landlocked Azerbaijani and possibly Central Asian oil to a Turkish deepwater port. Beyond its plans to

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Economic And Security Values of Caspian Energy for Azerbaijan. *Review of International Law and Politics* [*Uluslararası Hukuk ve Politika*] 6, 69–70.

[52] Ismailzade F (2006) *Russia's Energy Interests in Azerbaijan*. London: Global Market Briefings, Russian Foreign Energy Policy, 6–14.

[53] Ismailzade F and Cornell SE (2005) The Baku-Tbilisi-Ceyhan Pipeline: Implications for Azerbaijan. In: Starr FS and Cornell SE (eds.) *Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*. Washington, D.C.: Johns Hopkins Central Asia-Caucasus Institute Silk Road Studies Program, 79.

become an important oil transit country, Ankara also considered energy trade to be an important facilitator of postive relations with the Turkic-speaking nations of the Caspian.[54]

The United States also recognized a new opportunity in Azerbaijani hydrocarbon production. Washington, especially during the Clinton administration (1992–2000), perceived that through helping to transport landlocked Azerbaijan's oil production to world markets via pipelines that bypassed Russia and Iran, it could help to create more stability and peace in the Caspian region.[55]

Figure 2: Map of Oil and Natural Gas Pipelines in the South Caucasus
Map created by A.Y. Deezy
Source: http://ay-deezy.deviantart.com/art/South-Caucasus-Pipelines-186805101?q=&qo

In the late 1990s the U.S. backed several pipeline projects for the transport of oil (and later, natural gas) from Azerbaijan to world markets without passing through Russia (Figure

[54] Baran Z (2005) The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey. In: Starr SF and Cornell SE (eds.) *Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*. Washington, D.C.: Johns Hopkins Central Asia-Caucasus Institute Silk Road Studies Program, 104.

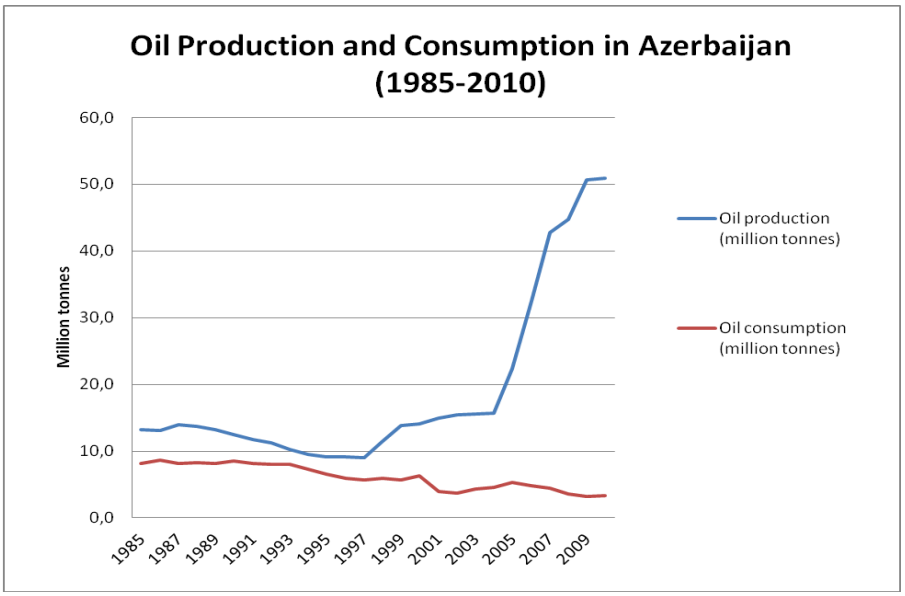
[55] Nichol J (2011) *Armenia, Azerbaijan, and Georgia: Political Developments and Implications for U.S. Interests*. Washington, D.C.: Congressional Research Service, 42–43.

2). The first project, in 1999, was the restoration/construction of the Baku-Tbilisi-Supsa oil pipeline, which carries a limited amount of Azerbaijani oil to the Georgian coast.[56] The more ambitious Baku-Tbilisi-Ceyhan (BTC) oil pipeline was meant to transport Azerbaijani oil to world markets.

Azerbaijan backed the BTC pipeline for of political-strategic reasons (as exemplified in the slogan, "Happiness is multiple pipelines") more than commercial interests when oil prices were low. Of course, the shortest route of oil export to world markets would have been through Iran, but this option was not viable because of U.S. opposition and unstable relations between Baku and Tehran. Thus the existing Baku-Novorossiysk pipeline provided the cheapest option. However, Azerbaijani leadership was also deeply concerned about Russia's control over the pipelines and the volatile pricing policy set by Russian energy transit system operator Transneft. For these reasons it was strategically logical and desirable for the most expensive and longest BTC pipeline to symbolize independence from the Russian transit system; therefore, this plan was strongly backed by the United States.[57]

[56] Georgia was at least as concerned about its own independence from Russia as Azerbaijan was. This anxiety caused Tbilisi to sign onto U.S.-backed oil and natural gas pipeline plans. For a description of Georgia's transit role, please see p. 51.

[57] Stulberg A (2007) *Well-Oiled Diplomacy: Strategic Manipulation and Russia's Energy Statecraft in Eurasia*. New York: State University of New York Press, 138–155.



3. Oil Production and Consumption in Azerbaijan 1985-2010 [58]
Source of Data: BP Statistical Review of World Energy Historical Data.

The "Contract of the Century" and the PSAs made it possible for the Azerbaijani government to easily utilize its hydrocarbon resources and also to exploit their international importance for three foreign-oriented aims: 1) to cement its independence in the face of its powerful neighbors; 2) to put pressure on Armenia to return the occupied Azerbaijani territories; and 3) to diversify its oil distribution to world markets completely free of Russian control of transit routes and materials.[59] Furthermore, as shown in Figure 3, increases in oil production and export not only paved the way to the stabilization of Azerbaijan's independence and provided the bedrock for its multi-vectoral foreign policy line but also sparked the revival of the Azerbaijani oil sector. Thanks to the oil price hike in the 2000s that

[58] Due to the lack of exact sources on export data, I display the difference of production and consumption as an indicator of amount of oil *available* for export, indicated by the oil surplus. Figure 2 reaffirms the statement that the output of Azerbaijani oil fields began to decrease in the 1980s and the rise appeared after the commencement of Chirag field in 1997 that was put under operation in the frame of the Contract of the Century.

[59] Ismaylov M (2010) Continuity and Change in Azerbaijan's Energy Diplomacy. *Caucasus Analytical Digest* 16: 2–5.

resulted in the surge of oil revenues,[60] oil production and export growth became a useful instrument for the political leadership in Baku to stabilize the country's internal politics.[61]

[60] As a result of the "Contract of the Century" and other PSAs, foreign investment increased 22.5 times between 1995 and 2005 and much of this revenue went to the energy sector. The growing oil output, the construction of the Baku-Tbilisi Ceyhan pipeline, growing export and rising oil prices on the world market, especially since 2006, Azerbaijan has been flooded with revenues from the oil sector—so much so that the Azerbaijani GDP increased threefold between 2003 and 2010. Oil revenues alone grew from 2.97 billion USD in 2006 to 22.7 billion USD in 2010. Ibadoglu G (2011) *Azerbaijan's Economic Model and Its Development Since Independence*. Baku: Economic Research Center. Source: http://www.erc-az.org/new/uploads/file/eng1.pdf. Retrieved: 14 October 2011.

[61] Özkan G (2006) Economic And Security Values of Caspian Energy for Azerbaijan. *Review of International Law and Politics* [*Uluslararası Hukuk ve Politika*] 6: 58-76.

CHAPTER 3

THE APPEARANCE OF NATURAL GAS EXPORT IN AZERBAIJAN'S FOREIGN POLICY

The commission of the BTC oil pipeline in 2006 fulfilled the objectives of Azerbaijan's oil export diversification strategy. The new pipeline would not only enable Azerbaijan to open up a main transit route for its oil export to the world market that bypassed Russia and Iran, it would also bring in enormous revenue by transporting growing volumes of oil. The year 2006, however, also meant the beginning of a new era when the simultaneous construction of the BTE gas pipeline and the start of production in the Shah Deniz gas field turned Azerbaijan from a net importer into a net exporter of natural gas and freed Baku from increasingly expensive Russian import. The growing interest of the European Union in diversifying its own natural gas import after the 2006 Russian-Ukrainian gas crisis dovetailed with Azerbaijan's need to find export markets for its growing gas output.[62]

3.1. An Old-New Natural Gas Exporter

Natural gas has been produced in Azerbaijan in the form of associated gas since the 1930s; its first gas field, the Bakhar, was opened in the mid-1950s. Azerbaijan was the largest gas producer within the USSR in the 1940s, but its relative share began to decline due to the

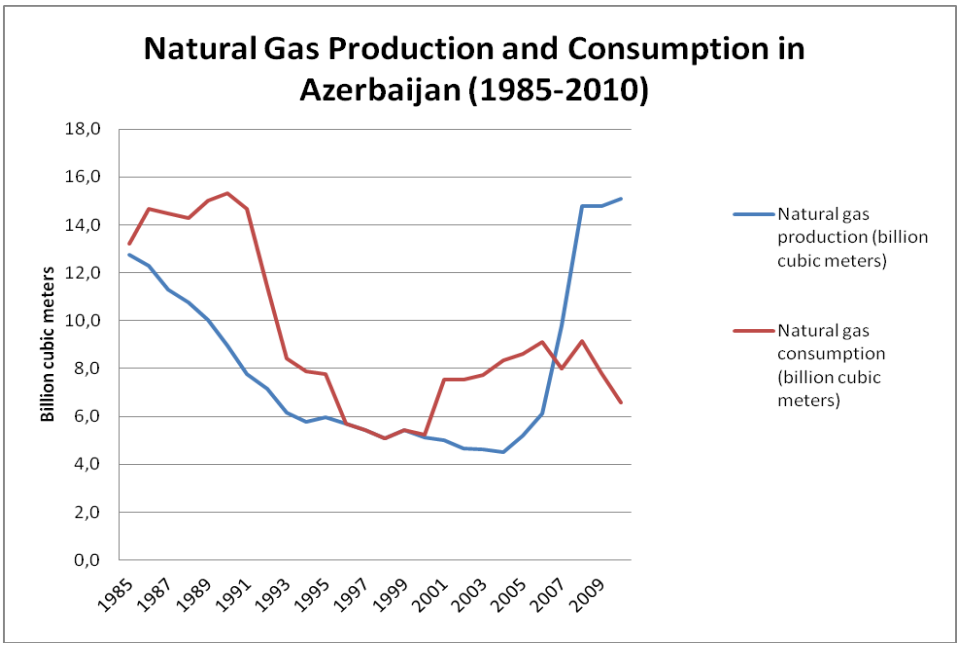
[62] Azerbaijan offers to sell gas to Europe. *Financial Times*, 27 May 2006. Source: http://www.ft.com/intl/cms/s/0/b969395e-ed1c-11da-a307-0000779e2340.html#axzz1jf12YgUh. Retrieved: 15 January 2012.

"gas revolution" of the 1950s when the first Russian and Ukrainian fields were opened.[63] By 1965, gas produced in the Azerbaijani SSR still supplied 10 percent of the entire Soviet output,[64] but in the 1960s the development of Central Asian fields and the giant fields of Western Siberia lowered the importance of Azerbaijani gas. Although gas generally played a secondary role to oil in the republic's energy industry, since the 1970s the energy mix began to shift to gas consumption. In the early 1970s the Soviets built a pipeline from Astara to Iran to cover the growing demand for gas from Iranian sources in the Caucasus, but this supply ceased after the Islamic revolution of 1979. By the 1980s, despite the decline in Azerbaijani gas production (Figure 4), natural gas emerged as the most important primary source of the Azerbaijani power supply. This centrality was compromised in 1987 when the Soviets constructed the Hajigabul-Mozdok gas pipeline to carry gas from the Russian SFR and Turkmen SSR.[65]

[63] Bowden J (2009) Azerbaijan: From gas importer to exporter. In: Pirani SM (ed.) *Russian and CIS Gas Markets and their Impact on Europe*. Oxford: Oxford Institute for Energy Studies, 206.

[64] Radó S (ed.) (1967) *Nemzetközi Almanach 1967*. Budapest: Kossuth Könyvkiadó, 943.

[65] In 1990 gas comprised more than 61 percent of the Azerbaijani energy mix. Bowden J (2009) Azerbaijan: from gas importer to exporter. In: Parani SM (ed.) *Russian and CIS Gas Markets and their Impact on Europe*. Oxford: Oxford Institute for Energy Studies, 207–208.



4. Natural Gas Production and Consumption in Azerbaijan 1985-2010 [66]
Source of Data: BP Statistical Review of World Energy Historical Data. [67]

After gaining independence from Russia in 1991 and subsequently opening up its hydrocarbon industry to foreign investors in order to stabilize its economy and positions against its powerful neighbors, Azerbaijan became party to a new source of revenue in 1999 when the PSA, led by BP and Statoil, discovered Shah Deniz—a new, relatively big[68] natural gas offshore field that was eventually found to contain not only enough resources to cover the

[66] Figure 4 shows the decreasing output of Azerbaijani natural gas fields in the 1980s that led to imports. Due to the shrinking economy between 1990-95 the consumption fell dramatically. In 1995 Baku ceased gas imports, then the consumption was limited to production. The imports resumed only in 2000. The rise in gas output in 2005 can be accounted to the affiliated gas produced at the Azeri and Chirag fields, the surge from 2007 shows the effects after the commission of the Shah Deniz Stage 1.

[67] The BP Statistical Review's data I use in this paper show the amount of production available for primary use, excluding gas flared or recycled. Furthermore, according to BP, their data represent standard cubic meters, measured at 15ºC and 1013 millibar (mbar); because it is derived directly from tonnes of oil equivalent using an average conversion factor, it does not necessarily equate with gas volumes expressed in specific national terms – this may cause discrepancies and margins in the data disclosed at various other media or official sources. For example, for the year of 2009 the BP data show 14.8 billion m3 as Azerbaijani natural gas extraction for primary use, while the Statistical Yearbook of Azerbaijan shows the gas extraction for primary use of 16.36 billion m3 for the same year. See *Statistical Yearbook of Azerbaijan 2010*. State Statistical Committee of the Republic of Azerbaijan. p 462.

[68] The Shah Deniz field is estimated to have at least 625 billion m^3 of natural gas. Source: http://www.offshore-technology.com/projects/shah_deniz/. Retrieved: 12 January 2009.

country's domestic needs but also to provide substantial volumes of gas for export. In 2001 this potential revenue stream began to pay off when Turkey contracted for 6.6 billion m^3/year of Azerbaijani natural gas.[69] On the strength of this contract, the Baku-Tbilisi-Erzurum gas pipeline project was submitted to the U.S.-backed BTC oil pipeline project. As a result, in 2006 the Baku-Tbilisi-Erzurum pipeline was constructed in a geographically and timely parallel with the BTE oil pipeline to supply the Turkish market.

In 2006 the first stage of the Shah Deniz field was put under operation and the BTE pipeline was commissioned as well. At the same time, for 2007 Gazprom raised its post-Soviet gas export prices close to its export prices for European countries that meant a twofold hike in gas prices *inter alia* for Azerbaijan.[70] Thanks to the development of Shah Deniz, however, Azerbaijan opted to suspend natural gas imports from Russia. Thus the BTE gas pipeline (similarly to the BTC oil pipeline) broke Russia's monopoly on the future transit of Azerbaijani gas export. In 2007 Azerbaijan became self-sufficient in terms of both gas and oil, as well as a net exporter of natural gas—a new status that goaded international and particularly European interests.

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3.2. Diversification of natural gas export

The 2001 contract for Azerbaijani natural gas exports to Turkey and the construction of the BTE gas pipeline that ran parallel to the BTC oil pipeline signalled a breakout from Azerbaijan's geographically and infrastructurally enclosed location similar to the one that

[69] BOTAS Natural Gas Sale and Purchase Agreements. Source: http://www.botas.gov.tr/index.asp. Retrieved: 18 April 2011.

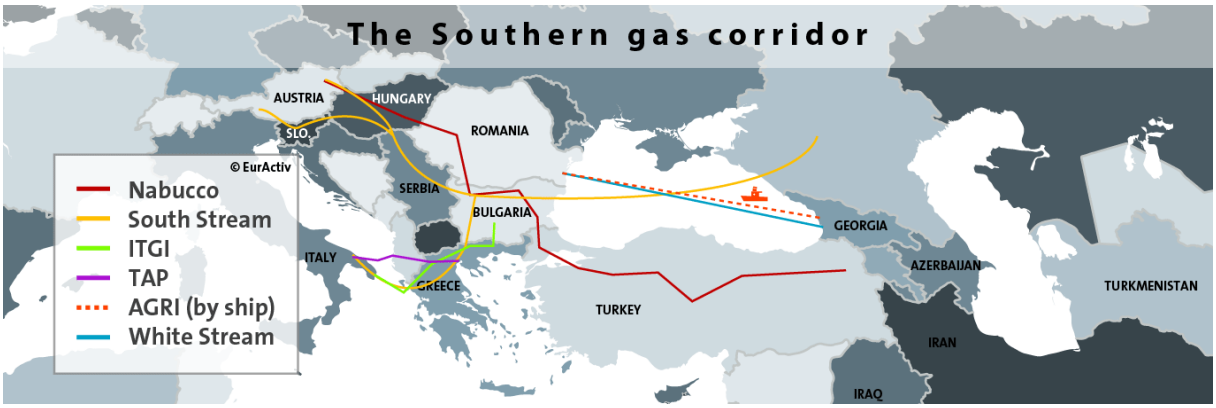
[70] In case of Azerbaijan it meant a price hike from 105 USD/thousand m^3 in 2006 to 235 USD/thousand m^3 in 2007, which seems to be practically a linkage to world oil prices. Bowden, J. 2009, "Azerbaijan: from gas importer to exporter" in *Russian and CIS Gas Markets and their Impact on Europe*, ed. S.M. Pirani, Oxford Institute for Energy Studies, Oxford: 224-225.

resulted from the diversification of oil export pipelines. When the Azerbaijani-Turkish gas trade agreement was signed, Azerbaijan was running gas pipelines in three directions: to Russia, via the Hajigabul-Mozdok pipeline (where the gas import came from), to Iran via the Baku-Astara pipeline and to Georgia via the Baku-Akstafa pipeline. The commission of the BTE pipeline through Georgia to Turkey in 2006 placed Azerbaijan in the focus of international attention more than anything else since the "Contract of the Century."

As a consequence of the 2005–2006 gas debate between Russia and the Ukraine, the European Union accelerated its plans to lessen its dependence upon Russia for natural gas. Because the EU was expected to dynamically increase its natural gas consumption,[71] beginning in 2006 European states and multinational companies promoted various pipeline projects to the EU that were meant to supply it with Azerbaijani gas resources (from the second stage of Shah Deniz) and, optionally, from Central Asian natural resources. All of the European pipeline plans, later referred to collectively as the European Southern Gas Corridor, were based on the hope that consistent supplies of Azerbaijani and even Central Asian natural gas would lower Europe's reliance on Russian natural gas. In Baku, the hope was for additional diversification of Azerbaijani export—this time to a non-interfering, reliable, large market. These plans, shown in Figure 5, included the Nabucco, promoted by the European Commission; the Trans-Adriatic Pipeline,[72] the Interconnector Turkey-Greece-Italy (ITGI);[73] the White Stream project;[74] and the Azerbaijan-Georgia-Romania Interconnector[75] (AGRI).

[71] In 2006 EU consumption was 564 billion m^3 but production was only 316 billion m^3. Therefore, 40 percent of EU consumption was supplied by import; of this proportion, 60 percent came from Russia. According to some estimations, due to rising consumption and declining production in the EU, by 2020 the ratio of imported gas may be as high as 80 percent of total consumption. Rempel H, Schmidt S, Schwartz-Sampera U, Röhling S and Brinkmann, K (2007) Die Rohstoffe Zentralasiens: Vorkommen und Versorgungen für Europa. *Osteuropa* 57(8–9): 433–448.

[72] Source: http://www.trans-adriatic-pipeline.com/. Retrieved: 1 February 2012.



5. The European Southern Gas Corridor Plans
Source: Euractiv

The Azerbaijani-EU energy relationship, especially in terms of the gas trade, were expressed in 2006 in a memorandum of understanding between the European Union and the Republic of Azerbaijan that stated, in part:

> The Azerbaijani energy sector is, and will remain, one of the major factors for the economic and social development of Azerbaijan through the exploitation and export of natural oil and gas resources, and the potential rapid development of transport and of transit of oil and natural gas. The gradual convergence with the EU's internal energy market, aiming ultimately at its integration, remains a shared priority for the EU and Azerbaijan.[76]

The document also mentions the successful completion of the BTC pipeline and Azerbaijan's potential importance as a transit and supplier of hydrocarbon resources to the EU from the Caspian region and Central Asia, especially from the Shah Deniz field.

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[73] Papandropoulos A (2011) What is the ITGI Pipeline Project? *NewEurope.eu*, 13 February 2011. Source: http://www.neurope.eu/articles/104750.php. Retrieved: 15 February 2011.

[74] Source: http://www.gueu-whitestream.com/main.php?id=1&lang=eng. Retrieved: 22 January 2012.

[75] Négyoldalú közös nyilatkozat az AGRI projekt jövőjéről [Fourlateral Common Declaration on the Future of the AGRI Project]. Source: http://www.kormany.hu/hu/nemzeti-fejlesztesi-miniszterium/klima-es-energiaugyi-allamtitkarsag/hirek/negyoldalu-kozos-nyilatkozat-az-agri-projekt-jovojerol. Retrieved: 22 February 2011.

[76] Memorandum of Understanding on a Strategic Partnership between the European Union and the Republic of Azerbaijan in the field of energy. 7 November 2006. http://ec.europa.eu/dgs/energy_transport/international/regional/caucasus_central_asia/memorandum/doc/mou_azerbaijan_en.pdf.

> In this context, ensuring a safe, transparent, reliable and secure transit system is of great importance for both the EU and Azerbaijan. With a view to enhancing European energy security, both sides particularly stress the vital role of the development of all means of transportation from the Caspian region, including the Baku-Tbilisi-Erzerum gas pipeline, and relevant multimodal transportation projects.[77]

The National Security Concept of the Republic of Azerbaijan (2007) also echoes the importance of the relations with its neigbors and the European Union as

> Close cooperation of the Republic of Azerbaijan with the European Union will contribute to the stability in the Caucasus and will promote the European values in the region.

The document also emphasizes the BTC oil and BTE gas pipelines that as a result of the cooperation between Azerbaijan, Turkey and Georgia contributed to global and European energy security and became a *"factor of stability in the region."*[78]

Azerbaijan received the European plans well.[79] With the establishment of natural gas export to Europe, Baku was poised to reach at least three important goals: export diversification to the well-paying European market, the cementing of political and economic independence and the beginning of regional stability. Azerbaijani leaders became impatient with the slow implementation of the European projects, however. In 2009 Baku not only criticized[80] the main European project, the ambitious Nabucco, but also committed itself to

[77] Ibid.

[78] National Security Concept of the Republic of Azerbaijan. 23 May 2007. http://merln.ndu.edu/whitepapers/Azerbaijan2007.pdf.

[79] At the Nabucco Summit in Budapest in January 2009, Azerbaijan was the only possible supplier to be represented by the president himself (Ilham Aliyev personally promoted the Nabucco plan). Elméletileg épülhet a Nabucco [Theoretically the construction of Nabucco can begin]. *Híradó.hu*, 27 January 2009. Source: http://www.hirado.hu/Hirek/2009/01/27/20/Elmeletileg_epulhet_a.aspx. Retrieved: 28 January 2009.

[80] See, for example, Baylarbayov V (9 June 2011). Presentation at the 18th Caspian Oil and Gas Conference, Baku.

alternative markets and emphasized its need for multiple pipelines.[81] These were not long in coming. In 2009 Azerbaijan and Russia agreed on Azerbaijani natural gas export to Russia; in January 2011 Azerbaijan and Iran signed a five-year contract for Azerbaijani gas export to Iran;[82] in 2009 and 2010 Azerbaijan signed a couple of agreements on gas trade with Syria (and with Turkey, about the infrastructure of this export);[83] and on 28 January 2011 Azerbaijan and Ukraine signed an intergovernmental agreement on natural gas trade.[84]

These negotiations indicate Azerbaijani interest in new markets; however, they may also be interpreted as pressure on Azerbaijan's European partners in light of the absence of an Azerbaijani delegation to the signing ceremony for the Nabucco Agreements in Kayseri in June 2011. This absence stood in marked contrast to President Aliyev's attendance at the Budapest Nabucco Conference in 2009.

3.3. Natural gas as a foreign policy instrument?

Azerbaijan's natural gas export diversification efforts may ultimately require long-term reliance on multiple pipelines, multiple markets and a variety of consumers. Azerbaijan needs gas revenues now, and will need them eve more when its oil output begins to decline.[85]

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[81] ten Hoedt R (2010) 'We do not want to depend only on one pipeline' Interview: Azerbaijani top negotiator Elshad Nassirov. *European Energy Review.* Source: http://www.europeanenergyreview.eu/site/pagina.php?id=2528. Retrieved: 15 November 2010.

[82] Азербайджан поставит в этом году в Иран 1 млрд. кубометров газа [Azerbaijan delivers 1 bcm gas to Iran this year]. *AzNews.org.* Source: http://aznewsorg.livejournal.com/3439458.html. Retrieved: 23 January 2011.

[83] Syria to import gas from Azerbaijan in 2011. *News.az*, 6 December 2010. Source: http://www.news.az/articles/economy/27863. Retrieved: 10 December 2010.

[84] Украина и Азербайджан подписали документы о поставках сжиженного газа. *РИАНовости Украина*, 28 January 2011. Source: http://ua.rian.ru/economy/20110128/78636447.html. Retrieved: 28 January 2011.

[85] Alhough revenues from natural gas exports in 2009 amounted to only 1 percent (oil revenues accounted for the other 91 percent) of its overall export revenues, Azerbaijan's gas exports to every market other than Russia weres sold for much lower prices than the European netback prices (given Turkey's insistence upon setting prices in 2001 and Georgia's subsidization). Future prices, of course, cannot be estimated on the basis of current ones. However, according to Wolfgang Peters (2011), the establishment of 10 billion m^3 annual natural gas

However, due to the parity between gas and oil expoert strategies, those similarities may be interpreted somewhate differently.

The most important point is that the diversification of oil export was in itself a strategic goal that enabled other essential goals to be met: the establishment of oil export transit to world markets (especially Europe), without passing through Russia or Iran, backed by the West, and the resulting counterbalance with regional powers. A similar process is taking place with natural gas. Azerbaijan's primary diversification need, and goal, is the establishment of gas pipelines to Europe. Such pipelines will provide access to a large, reliable, high-paying, with stable demand: the European "netback market that has been mentioned by various Azerbaijani leaders.

One strategic point must still be considered, however:

> Close cooperation of the Republic of Azerbaijan with the European Union will contribute to the stability in the Caucasus"[86][…] „trilateral strategic partnership and deepening cooperation between Azerbaijan, Georgia and Turkey has developed into a factor of stability in the region. This cooperation, resulting in successful implementation of infrastructure projects such as Baku-Supsa, Heydar Aliyev Baku-Tbilisi-Ceyhan export oil pipelines and South Caucasus gas pipeline (Baku-Tbilisi-Erzurum), has increased the importance of the Black Sea and Caspian Sea regions, contributed to the European and global energy security and laid the foundations for the new vital and secure energy source for Europe.[87]

Thus, the establishment of natural gas export to Europe that creates a direct infrastructural connection with this large extra-regional partner is a strategically crucial

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export to Europe (counted on the IEA Price Forecast for 2015) in and of itself would equal the revenue of 2.3 billion euros for Azerbaijan (roughly 3 billion dollars, or 20% of the overall 2009 export revenues). Peters W (9 June 2011). Caspian gas and European markets: The commercial value chain. Baku: 18th Caspian Oil and Gas Conference.

[86] National Security Concept of the Republic of Azerbaijan. 23 May 2007. Retrieved: http://merln.ndu.edu/whitepapers/Azerbaijan2007.pdf.

[87] National Security Concept of the Republic of Azerbaijan. 23 May 2007. Retrieved: http://merln.ndu.edu/whitepapers/Azerbaijan2007.pdf.

reason, beyond its commercial value,[88] for Baku to prioritze the European markets over its other ones. Official hints and remarks reveal this need for "big new natural gas markets reliably regulated by law, and where there is demand for fuel"[89] and that Europe continues to be the market of the future for Azerbaijan.[90]

Azerbaijan's consideration of Europe as a primary market has also been emphasized by the Joint Declaration on the Establishment of the Southern Gas Corridor signed on 13 January 2011 by the EU and Azerbaijan. In addition, the 15 agreements signed in Izmir by Azerbaijan and Turkey on October 25 2011 resolved the longstanding price disputes between Ankara and Baku, established mutually agreeable transit and officially commited 10 billion m^3 of the annually projected maximal 16 billion m^3 gas output of the second stage of the Shah Deniz field for European export and the remaining 6 billion m^3 for Turkey.[91] These settlements have paved the way for the implementation of at least part of Azerbaijan's ambitious European Southern Gas Corridor plans.

Azerbaijan may follow a multi-vectoral or balanced natural gas export policy for its growing natural gas output; if so, it will be weighted toward European markets. Compared to its current markets (e.g., Turkey, Georgia, Russia, Iran and Syria) and the ones currently under negotiation (e.g., Ukraine), Europe is the biggest, best paying, most reliable market

[88] Beyond the strategic considerations, high transit fees for gas transit through Russia would force prices too high. Добронравин НА (2008) Нефть, газ и «транспортное проклятие»: Казахстан, Туркменистан, Азербайджан. In: *Нефть, Газ, Модернизация Общества*, eds. Добронравин (Добронравин НА and Маграния О (eds.). Saint Petersburg: Saint Petersburg State University Advanced School of Economics, 444–445.

[89] Ilham Aliyev: Azerbaijan needs large and robust natural gas markets. *Azerireport*, 7 July 2011. Source: http://azerireport.com/index.php?option=com_content&task=view&id=2800. Retrieved: 15 July 2011.

[90] SOCAR President: Europe the main market for Azeri gas. *NaturalGasEurope*, 24 January 2012. Source: http://www.naturalgaseurope.com/socar-president-europe-the-main-market-for-azeri-gas-4639. Retrieved: 25 January 2012.

[91] SOCAR's Izmir ceremonies. *SOCAR.az*. Source: http://new.socar.az/socar/en/news-and-media/news-archives/news-archives/2011/10/27. Retrieved: 30 October 2011.

with stable demand. The stability of demand in Turkey, Russia and Iran is debatable given that Turkey has already "overcontracted" itself, while the latter two countries, despite their respective claims of willingness to buy as much gas as Baku can sell, already own the largest gas reserves in the world and thus have their own energy policy interests. For these reasons, these countries are not only customers but also real or potential market competitors for Azerbaijan. Furthermore, both Moscow and Tehran are capable of intervening in Azerbaijan and indeed have already done so; Georgia is a small market; both Syrian output and political situation are volatile;[92] and Ukraine has an infamous record of non-payment despite the large demands of its energy-intensive economy.[93]

Without question, the exploration of Shah Deniz opened up new opportunities for Azerbaijan, which became self-sufficient in natural gas as a result. However, the construction of the BTE gas pipeline also exposed Azerbaijan's infrastructural dependence on Russia. The further development and diversification of natural gas export to Europe through pipelines will both cater to a new a new market and also fulfill Azerbaijan's strategic goal of attaining regional stability. Nonetheless, the slow implementation of European projects has compelled Azerbaijan not only to establish other markets such as Russia and Iran but also to explore future export options such as Syria and Ukraine. The following chapter examines whether and how this overall strategy appears in the Azerbaijani decision making system and what role natural gas may have in the Azerbaijani energy industry.

[92] Energy Information Administration (2011) Syria Analysis. Source: http://www.eia.doe.gov/countries/cab.cfm?fips=SY. Retrieved: 18 April 2011.

[93] Pirani SM (2009). Ukraine: Gas dependent state. In: Pirani SM (ed.) *Russian and CIS Gas Markets and their Impact on Europe*. Oxford: Oxford Institute for Energy Studies.

CHAPTER 4

AZERBAIJAN'S FOREIGN AND ENERGY POLICY DECISION MAKING AND THE PLACE OF NATURAL GAS IN THE ENERGY INDUSTRY

As has been discussed in chapters 1–3, foreign policy and energy are interconnected in Azerbainjan. How these connections are made by decision makers how the strategic interests described in the second and third chapters appear in the decision making and what commercial interests underly the decisions are the subjects of this chapter.

Although the formal aspects of these matters can be traced, they do not offer a complete picture of the whole decision making system. As S. Frederick Starr (2006) noted, informal networks, kinships and power brokers/clans ("Politics B") makes important behind-the-scenes decisions about public policy ("Politics A)[94] Although Azerbaijan's authoritarian system allows key decisions to be made by the president, he rules in cooperation with an elite based on family networks, business interests and strongmen from the top of the pre-independence bureaucracy.[95] This small decision-making elite operates in non-transparent way, without real popular participation. This lack of separation between economic and political elites, and the dovetailing of their interests, has a major impact on Azerbaijan's

[94] Cornell Svante E (2011) cites Starr in *Clans, Authoritarian Rulers and Parliaments in Central Asia*. Washington, D.C.: Johns Hopkins Central Asia-Caucasus Institute Silk Road Studies Program.

[95] International Crisis Group (2010) *Azerbaijan: Vulnerable Stability* (Europe Report no. 207). Source: http://www.crisisgroup.org/~/media/Files/europe/caucasus/azerbaijan/207%20Azerbaijan%20-%20Vulnerable%20Stability.pdf. Retrieved: 5 December 2010.

foreign policy.[96] Energy policis are used not only to maintain Azerbaijan's international positions but also to maintain internal the status quo—with the help of energy revenues.

4.1. Azerbaijan's foreign policy formulation and decision making system

Since independence, Azerbaijan's foreign policy making has been both largely personalized and connected to the person of the president. The Constitutional Act on the State Independence of the Republic of Azerbaijan (August 30, 1991)[97] and the Constitution of the Republic of Azerbaijan (November 12, 1995)[98] both define a presidential republic in which the executive power belongs to the president. The constitution explicitly declares that members of the main governmental body, the Cabinet of Ministers established by the president, are subordinates of the president and report to him. The constitution also declares that the procedures of this cabinet are defined by the president.[99]

This impact of the strong presidential power and the authoritarian character of the political system is evident in the changes made by Azerbaijani presidents to Azerbaijani foreign policy.[100] Ayaz Mutallibov (1991–92), the last first secretary of the Azerbaijan Communist Party and the first president, established a pro-Russia foreign policy line.

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[96] Kjaernet H (2010) Azerbaijani-Russian relations and the economization of foreign policy. In: Overland I, Kjaernet H and Kendall-Taylor A (eds.) *Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan*. London: Routledge, 155.

[97] The Constitutional Act on the State Independence of the Republic of Azerbaijan. Source: http://www.azerbaijan.az/portal/History/HistDocs/Documents/en/09.pdf. Retrieved: 1 February 2012.

[98] The Constitution of the Republic of Azerbaijan. Source: http://www.azerbaijan.az/portal/General/Constitution/constitution_01_e.html. Retrieved: 1 February 2012.

[99] The Constitution of the Republic of Azerbaijan. Source: http://www.azerbaijan.az/portal/General/Constitution/constitution_01_e.html. Retrieved: 1 February 2012.

[100] Cornell SE (2011) *Azerbaijan Since Independence*. New York: M.E. Sharpe, New York, 301–317.

His successor, the democratically elected Abulfaz Elcibey (1992–93) of the Azerbaijani Popular Front, followed a foreign policy line that was pro-Western and pro-Turkish but anti-Russia and anti-Iran. His policy decisions were largely based on avoiding the Russia-dominated Commonwealth of Independent States (CIS) and negotiating with Western oil companies over investments in the Azerbaijani energy sector that were meant to bankroll the country's independence.

Heydar Aliyev's (1993-2003) seizure of power in June 1993 after the domestic economic and political turmoil and losses sustained in the Karabakh war (1988-94) meant a new, pragmatic turn in Azerbaijani foreign policy. Aliyev placated Russia by affixing Azerbaijan's ratification to the CIS and catered to the Russian elite by bringing Lukoil into resumed negotiations with foreign investors. The "Contract of the Century," which directly influenced Azerbaijan's energy revenue hike and Aliyev's multi-vectoral foreign policy, helped stabilize Azerbaijan's regional and internal positions and independence. Thus far, the President Ilham Aliyev (2003–) has followed both his father's multi-vectoral foreign policy line and his utilization of growing energy revenues in domestic as well as foreign policy.

4.2. Azerbaijan's energy policy decision making

The process of Azerbaijani energy policy decision making is as centralized as the process of crafting foreign policy. The State Oil Company of the Azerbaijan Republic (SOCAR), formed by the merger of Soviet companies Azerneft and Azneftkimiya in September 1992, is the key player in the Azerbaijani energy industry. Despite the establishment in 2004 of the Ministry of Industry and Energy, which was supposed to supervise the company, the president and the PSAs have granted it largely symbolic duties. SOCAR, one of Azerbaijan's biggest taxpayers, operates much of the onshore production

facilities and all of the oil and gas production assets inherited from the Soviet era. Beyond production, the company is involved in petroleum policy and regulation, and plays a central role in negotiations with international investors.

SOCAR is also an important player in policy formulation.[101] Personal connections and loyalty are required from the company's top leadership; as a result, of its presidents have been close associates of the respective presidents of Azerbaijan. Particularly since Ilham Aliyev's rise to power (not independently of his experience at SOCAR, where he was vice-president from 1994 to 2004) the president has become even more active in SOCAR's management because the state energy company is intended to deliver for political as well as economic benefits.[102] SOCAR's status as a "state within the state" that is not only used by the ruling elite for its own aims but is also considered to be a hotbed of nepotism and corruption.[103]

SOCAR, the only entity authorized to negotiate PSAs with international companies, has brought about more than two dozen PSAs in the last 18 years that are all largely similar to each other. After agreement has ben reached between SOCAR and a contractor, each PSA is ratified by the Milli Majlis (parliament) and functionally[104] becomes a law, signed by the president. Project management is handled by official Management Committees that are

[101] Kjaernet H (2010) The State Oil Company SOCAR: A microcosm of Azerbaijani development? *Caucasus Analytical Digest* 16: 5–8.

[102] Lussac S (2011) *The State as a (Oil)Company? The Political Economy of Azerbaijan*, GARNET Working Paper. pp 22-25. Source: http://www.garnet-eu.org/fileadmin/documents/working_papers/7410.pdf. Retrived: DATE.

[103] Gojayev V (2010) Resource Nationalism Trends in Azerbaijan, *RUSSCASP Working paper*, 2010 March. p14.

[104] Bati A (2003) The Legal Status of Production Sharing Agreements in Azerbaijan, *Journal of Energy and Natural Resources Law*, 21: 153–167.

formed by the contractors and SOCAR and chaired by SOCAR delegates.[105] This arrangement ensures close surveillance of every operation by the Azerbaijani side.

SOCAR also plays a key role in Azerbaijan's energy export transit system. As Samuel Lussac (YEAR) described, Azerbaijani oil and gas export transit systems are dominated by SOCAR, the operator company of each system and BP (the largest stakeholder in both the AIOC consortium and the Shah Deniz PSA). The interests and interrelations among firms controlled by the Azerbaijani presidency and various elite groups (e.g., Azersun), joint ventures, and, finally, companies and projects owned by Western entities collectively control Azerbaijan's transit network. Since the mid-2000s, however, through SOCAR the presidency has been attempting to exert more control over non-Western-owned parts of the transportation network.

In short, given the BP's central role in the operations of ACG oil, Shah Deniz gas fields and both the BTC and BTE pipelines, along with SOCAR's position as the most authoritative respresentative of the Azerbaijani state in all oil- and gas-related negotiations, no decisions can be made without the Azerbaijani government and BP.[106] Certainly, given the importance of transit infrastructure in the natural gas trade, these relations also have important implications for foreign policy. Although Azerbaijan has not started down the road of resource nationalism, as Kazakhstan or Russia have done, because oil has become the key

[105] Bagirov S (2007) *Oil of Azerbaijan: Revenues, Expenses and Risks (View from 2007)*. Budapest: Central European University, 17–49.

[106] Lussac S (2011) *The State as a (Oil)Company? The Political Economy of Azerbaijan*, GARNET Working Paper. No 74/10. Source: http://www.garnet-eu.org/fileadmin/documents/working_papers/7410.pdf. Retrieved:.5 February 2012.

diplomatic tool for Azerbaijani leadership; moreover, Baku cannot do without Western investment and state of-the-art technology.[107]

The distribution of energy revenues is also a crucial part of the energy policy decision making system. The first major recipients of oil revenues in Azerbaijan were the state budget and SOCAR. However, given Azerbaijan's limited oil resources (which will decline after the expected peak in the first half of the 2010s), the State Oil Fund (SOFAZ) was created in 1999 upon international advice in order to accumulate the revenues of PSA projects and preserve them for future generations. SOFAZ is controlled by the president and its resources are allocated by presidential decree. As a result of the overwhelming importance of production of fields under PSAs (especially the ACG), SOFAZ is the key recipient of energy revenues, large parts of which are transferrred directly into the state budget. Nonetheless, due to the overcentralized, authoritarian Azerbaijani political system, imperfect laws and the dominant role of the executive branch, inefficient management of energy revenues has raised some major concerns.[108]

4.3. The role of natural gas export in Azerbaijan's policy making

Azerbaijani energy policy now has an asset of growing importance: the natural gas industry, particularly through the prospects of increasing natural gas exports. Natural gas has been produced in Azerbaijan since the 1930s. However, both the Azerbaijani energy industry and the production of its natural gas fields began to decline in the 1980s, after the discovery of the Western Siberian natural gas fields and the Soviet Union's subsequent neglect of

[107] Gojayev V (2010) Resource Nationalism Trends in Azerbaijan, *RUSSCASP Working paper*, 2010 March. pp 8-9.

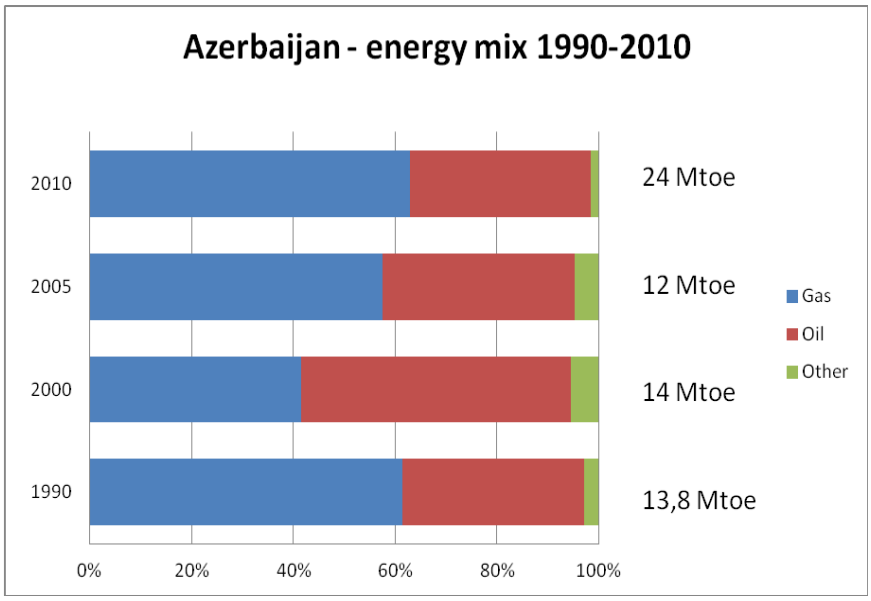
[108] Bagirov S (2007) *Oil of Azerbaijan: Revenues, Expenses and Risks (View from 2007)*. Budapest: Central European University.

Azerbaijan's energy potential (to the point that Baku was compelled to import gas from the Russian and Turkmen SSR). Despite this situation, natural gas also emerged in the 1980s as the most important source of Azerbaijani primary power supply (see Figure 6).[109]

Azerbaijan's energy industry began to revive on 20 September 1994 with the signing of the "Contract of the Century," its first PSA, that involved 11 foreign oil companies. However, despite SOCAR's no-cost acquisition of associated gas from the ACG fields, that gas has not been sufficient for both domestic consumption and oil production. This situation changed in 1999 when the PSA led by BP and Statoil found a new, relatively large[110] offshore natural gas field, Shah Deniz. This field contains enough resources not only to cover domestic needs but also to provide substantial volumes of gas for export. In 2006 its first stage was put under operation at the same time as the BTC oil and BTE gas pipelines were commissioned. The Shah Deniz field has enabled Baku both to suspend Russian import, which was becoming more and more expensive, to end Azerbaijan's dependence on Russian sources and, in 2007, to become a net exporter of natural gas.

[109] In 1990 the share of gas accounted for more than 61 percent of the Azerbaijani energy mix. Bowden J (2009)Azerbaijan: From gas importer to exporter. In: Pirani SM (ed.) *Russian and CIS Gas Markets and their Impact on Europe*. Oxford: Oxford Institute for Energy Studies, 203–208.

[110] The Shah Deniz field is estimated to have at least 625 billion m^3 of natural gas. Source: http://www.offshore-technology.com/projects/shah_deniz/. Retrieved: 12 January 2009.



6. Azerbaijan – energy mix 1990-2010
Sources of Data: Bowden, Julian [2009]: p 207. Economist Intelligence Unit

Although more than 70 percent (by far the largest share) of Azerbaijan's natural gas production now comes from Shah Deniz[111] and will continue to do so until 2020, substantial reserves remain that can be put under production after 2020. For example, in late 2010 the first SOCAR-led gas discovery project found and began to develop the Umid, an offshore natural gas. In September 2011, Total discovered a major offshore gas field, Absheron,[112] that is expected to boost Azerbaijan's gas export capacity in the 2020s. Azerbaijan may have an export potential of 35 billion m^3 annually by 2035.[113] With these assets, it is no surprise that Azerbaijan has begun to present itself as a significant future gas exporter.[114]

[111] SOCAR Economics and Statistics. Source: http://new.socar.az/socar/en/economics-and-statistics/economics-and-statistics/gas-production. Retrieved: 20 February 2012.

[112] Total discovers vast gas field in Caspian Azerbaijani sector. *News.az* (9 September 2011). Source: http://www.news.az/articles/economy/44084. Retrieved: 10 September 2011.

[113] Caspian oil and gas exports are poised for take-off. *International Energy Agency* (15 March 2011). Source: http://www.iea.org/index_info.asp?id=1881. Retrieved: 13 June 2011.

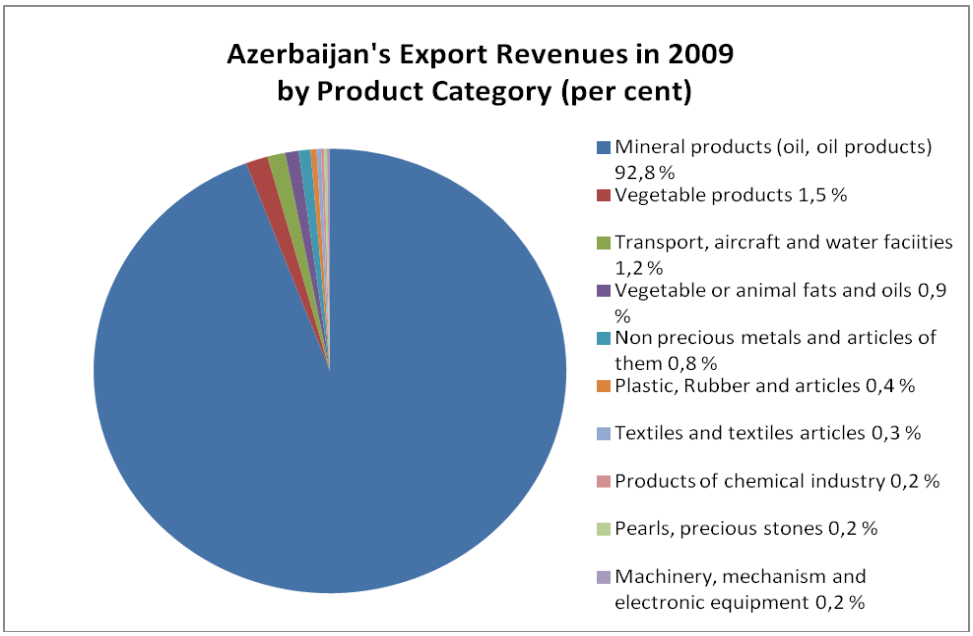
[114] Azerbaijan starts to present itself to world as gas country: Ilham Aliyev. *News.az* (12 November 2011). Source: http://www.news.az/articles/official/48587. Retrieved: 14 November 2011.

Despite its substantial growth, however, natural gas export has not yet contributed a significant share to Azerbaijan's energy-dominated export revenues (see Figure 7). According to data in the *Azerbaijani Statistical Yearbook*, in 2009 natural gas export revenues were about 1 percent (125 million USD) of Azerbaijani export revenues (oil revenues accounted for 92 percent (13.5 billion USD). However, Azerbaijan has been exporting gas to Turkey, Georgia and Russia and in 2011 signed a five-year gas export contract with Iran. Of these partners, only Russia pays prices that compare to the European netback prices. Turkey (based on a 2001 contract) and Georgia (a key transit state) have been paying largely subsidized prices, while Iran, having promised to pay "European" prices, has not yet purchased gas from Azerbaijan at all.

When gas exports to Europe are established, substantially larger gas revenues are expected. Although gas prices when the first (expected) flow of gas to Europe begins in 2017 cannot now be estimated, Azerbaijan is expected to realize higher revenues by at least one order of magnitude. Dobronravin (2008) mentioned 1 billion USD per annum[115] and Peters (2011) has estimated roughly 3 billion USD of annual income for Baku if 10 billion m^3 of gas can be exported yearly to Europe.[116]

[115] Добронравин НА (2008) Нефть, газ и «транспортное проклятие»: Казахстан, Туркменистан, Азербайджан. In: Добронравин НА and Маграния О (eds.) *Нефть Газ, Модернизация Общества*, (eds.). Saint Petersburg: Saint Petersburg State University Advanced School of Economics, 501.

[116] Peters W (9 June 2011) Caspian Gas and European Markets: The commercial value chain. Baku: 18th Caspian Oil and Gas Conference, Baku.



7. Azerbaijan's export revenues in 2009 by product category
Source: Statistical Yearbook of Azerbaijan 2010[117]

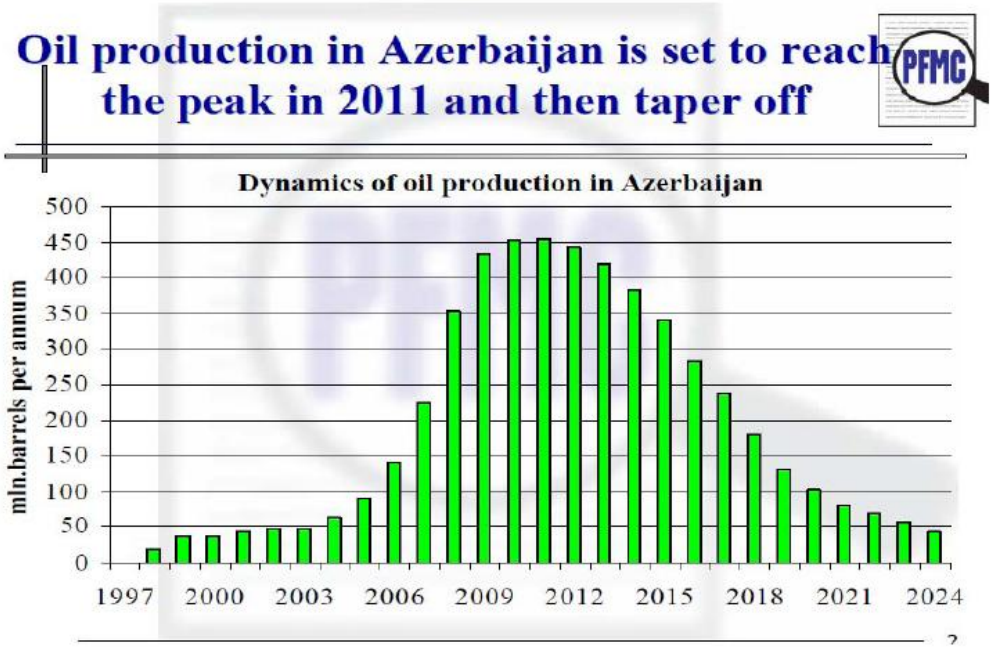
Beyond their inherent foreign policy implications, energy resources—especially oil—also have commercial benefits. As we have seen, energy revenues have been considered a key factor in the stabilization of Azerbaijan's political order and economy by the ruling political elite.[118] However, concentrating these financial benefits within the elite has had the side effect creating wider social gaps, and this situation is poised to become a major destabilizing factor in the future.[119] Not only are oil production and revenues both expected to peak in the first half of this decade, Azerbaijan's economy is still overwhelmingly dependent on energy revenues. Despite the creation of SOFAZ to manage and preserve oil revenues for future

[117] In the statistical data natural gas revenues are treated together with oil revenues under the label "mineral products (oil, oil products)."

[118] In 2010, oil revenues contributed 63 percent of all budget revenues. *Economic Review of Azerbaijan 2010.* Baku: Economic Research Center, 16.

[119] Özkan G (2006) Economic and security values of Caspian energy for Azerbaijan. *Review of International Law and Politics* [*Uluslararası Hukuk ve Politika*] 6: 74–76.

generations, spending has not been measured in terms of efficiency[120] and SOFAZ funds are largely used to cover the current expenses of the state administration.[121]



8. Dynamics of oil production in Azerbaijan
Source: Vugar Gojayev [2010] cites data by Ingilab Ahmedov, Public Finance Monitoring Centre

From figure 8 it is obvious that the Azerbaijani political elite will need additional if maintaining the country's internal stability. We may therefore assume that future natural gas income will be used to offset future declines in oil revenue. To what extent natural gas revenues will affect Azerbaijan's energy revenue cannot be known, particularly because prices cannot be predicted; however, it is speculated that gas revenues equalled 20% of the 2009 oil revenues. What is known is that the shale gas "revolution" and the LNG trade are

[120] Center for Economic and Social Development (2007) *Strategy for State Oil Fund of Azerbaijan Republic.* Baku: Center for Economic and Social Development, 13.

[121] Four main areas of state spending have grown due to the oil windfall: management (including wages and pensions), state investment, social needs and the army. Bagirov S (2007) *Oil of Azerbaijan: Revenues, Expenses and Risks (View from 2007)*. Budapest: Central European University, 11–12.

transforming regional markets into a more interconnected system and gas supply is growing in Europe. Nonetheless, the long-term impact of shale gas on prices cannot be estimated.[122]

As we have seen, Azerbaijan's foreign policy and energy policy (especially energy export) are strongly interrelated; in addition, foreign policy and energy policy decisions are made by the a largely unchanging cast of political actors (first and foremost, the president) and (regarding extraction and operation) investors such as BP. Natural resources, especially oil, have not only been used for foreign policy goals but have also been also tools for the elite to use in the stabilization of the country's internal political order and economy. Moreover, the potential of natural gas as a strategic asset has grown since 2007 when it became evident that Azerbaijan may become a net exporter. These prospects of growing production and export provide new opportunities for Baku to further stabilize its positions along the pipelines. Future natural gas revenues may also allow the elite preserve geopolitical and economic stability in the era of declining oil revenues in the largely energy revenue-dependent Azerbaijan.

[122] Rogers, H.V., 2012, *The Impact of a Globalising Market on Future European Gas Supply and Pricing: The Importance of Asian Demand and North American Supply*, Oxford Institute for Energy Studies, Oxford.

CHAPTER 5

THE INTERNATIONAL IMPLICATIONS OF AZERBAIJANI NATURAL GAS EXPORT

From its earliest days, the establishment of Azerbaijani natural gas export has had international political implications. Azerbaijan's first post-1991 gas export pipeline, the Baku-Tbilisi-Erzurum (BTE) was built in order to transit the output of the first phase of the Shah Deniz field to Turkey through Georgia. As a landlocked country, Azerbaijan must consider transit and relations with transit countries as crucial factors in its natural gas export strategies. As it was in Azerbaijan's oil export plans, George has been the most important transit country for gas export to Azerbaijan's first market, Turkey, and is the preferred direction of gas export to Europe. This South Caucasus country to the east is likely to remain the preferred route for gas export, particularly because the frozen Nagorno-Karabakh conflict prevents gas transit to the west, through Armenia.

Slow implementation of its European plans and its own growing gas output, have caused Azerbaijan to begin exporting gas to partners other than Turkey and Georgia.

5.1. Georgia: a transit country of key importance and a small market

The obvious relevance and challenges of transit issues are obvious can be clearly seen in the Azerbaijani foreign policy decision to make Georgia its key transit state. Not only do the two countries share common security concerns as former Russian states, Azerbaijan has demonstrated its Georgian energy strategy with subsidized prices and asset acquisition

similarly to the ways that Russia has utilized its energy resources as leverage in its foreign policies regarding other post-Soviet countries.[123]

For Azerbaijan, the basic options for oil and gas transit to western markets have been Russia, Georgia (and Turkey) and Iran. Of course, the choice of the Georgian route was also made for political reasons, as shown by the construction of the Baku-Tbilisi-Supsa and Baku-Tbilisi-Ceyhan oil pipelines and the Baku-Tbilisi-Erzurum gas pipelines through Georgia instead through Russia or Iran.

Georgia's attitudes are of critical importance to the successful implementation of western natural gas export from the landlocked Azerbaijan. Fortunately, Georgia's stances have been quite positive. In the 1990s, for example, Tbilisi was determined to strengthen its independence from Russia by participating in pipeline projects aimed at carrying Azerbaijani oil (and later, natural gas) to world and regional markets, respectively.[124] The desire to break free from its dependence on oil and natural gas imports from Russia was also a strong incentive for Tbilisi to diversify its hydrocarbon imports with Azerbaijani resources; a desire that grew after further deterioration of relations with Moscow culminated in the Russo-Georgian conflict of 2008. Another important factor for Georgia is that Azerbaijan sells its gas for lower prices than Russia does. Moreover, Tbilisi receives natural gas as a transit fee in exchange for being the key transit country forAzerbaijani hydrocarbon resources.[125] In 2008,

[123] Kjaernet H (2010) Azerbaijani-Russian relations and the economization of foreign policy. In: Overland I, Kjaernet H and Kendall-Taylor A (eds.) *Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan*, London: Routledge, 150.

[124] Georgia has already been participating in the transport of Azerbaijani oil and natural gas. The Baku-Tbilisi-Supsa oil pipeline (implemented in 1999), the Baku-Tbilisi-Ceyhan oil pipeline (implemented in 2006) and the Baku-Tbilisi-Erzurum natural gas pipeline (implemented in 2006) already cross Georgian territory.

[125] Tokmazishvili M (2009) Georgia's Gas Sector. In: Pirani SM (ed) *Russian and CIS Gas Markets and their Impact on Europe*. Oxford: Oxford Institute for Energy Studies, 263–265.

for the five-year fixed price of $120/1000 m^3 gas Azerbaijan (using energy as a policy tool as Moscow has done) stabilized its positions and leverage in Georgia and, through SOCAR, effectively took over significant parts of the Georgian gas distribution network.[126] This move, added to its other investments and acquisitions in the Georgian energy sector since 2006, has made the Azerbaijani state-owned oil company the country's biggest taxpayer.[127]

Aside from its strategic importance in the secure flow of oil and gas through the Baku-Tbilisi-Supsa, BTC oil and BTE gas pipelines, Georgia is also central to Azerbaijan's plans to export gas to Europe and Ukraine in the future. In order to implement the onshore phase of the AGRI project as well as the Azerbaijani-Ukrainian LNG trade, an LNG compressing terminal and a pipeline of sufficient capacity will have to be built from Azerbaijan to the Georgian seashore alongside the present oil and natural gas pipelines.

5.2. Turkey: The strategic ally, first contracted market and future transit state

Not only has Turkey participated in the diversification of Azerbaijani oil export (BTC) and became Azerbaijan's first natural gas market, Ankara's energy hub strategy is to make Turkey the key transit state of Caspian natural gas resources to Europe.

Not long after the discovery of Shah Deniz, in 2001 Turkish state-owned crude oil and natural gas pipelines and trading company Botas contracted 6.6 billion m^3/year of Azerbaijani natural gas.[128] The subsequent construction of the BTE gas pipeline supplied the energy-

[126] Kjaernet H (2010) Azerbaijani-Russian relations and the economization of foreign policy. In: Overland I, Kjaernet H and Kendall-Taylor A (eds.) *Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan*. London: Routledge, 156.

[127] Azerbaijan state oil company becomes Georgia's biggest taxpayer in 2009. *Today.az* (27 January 2010). Source: http://today.az/news/business/60308.html. Retrieved: 6 January 2012.

[128] BOTAS Natural gas sale and purchase agreements. *Botas*. Source: http://www.botas.gov.tr/index.asp. Retrieved: 18 April 2011.

hungry Turkish economy. Turkey also considers Azerbaijan's European gas import diversification plans to be a great opportunity. Because pipelines from the Caspian to Europe are slated to pass through Turkey, Ankara has decided to consider the country a regional energy hub. Although the natural gas demands of the Turkish economy have been rising since the late 1990s, due to too-optimistic economic growth predictions Turkey has overcontracted itself for natural gas (Figure 9).

Agreements	Volume BCMA (During The Plateau Period) (Billion m³/year)	Date Of Signature	Duration (Years)	Status
Russian Fed. (Westward)	6	14 February 1986	25	In operation
Algeria (LNG)	4	14 April 1988	20	In operation
Nigeria (LNG)	1.2	9 November 1995	22	In operation
Iran	10	8 August 1996	25	In operation
Russian Fed. (Black Sea)	16	15 December 1997	25	In operation
Russian Fed. (Westward)	8	18 February 1998	23	In operation
Turkmenistan	16	21 May 1999	30	-
Azerbaijan	6.6	12 March 2001	15	In operation

9. Botas natural gas sale and purchase agreements
Source: http://www.botas.gov.tr/index.asp?id=6

Turkey has had three major goals: 1) to make use of its location as leverage for speeding up its access to the European Union; [129] 2) in light of its over-contracting, to keep the purchase price of Azerbaijani (and expensive Russian[130]) gas low and possibly re-export it to Europe; and 3) given the fact that all the Azerbaijani (and if implemented, Central Asian)

[129] Tekin A and Williams PA (2011) *Geo-Politics of the Euro-Asia Energy Nexus*. Basingstoke: Palgrave Macmillan, 145–149.

[130] Considering Russian gas too expensive, Turkey canceled its contract to export gas via a western pipeline from Russia. *Hurriyet* (2 October 2011) Turkey cancels gas deal with Russia, consumer prices hike. Source: http://www.hurriyetdailynews.com/default.aspx?pageid=438&n=turkey-cancels-gas-deal-with-russia-consumer-prices-hike-2011-10-02. Retrieved: 22 October 2011.

gas would flow through its territory, trying to obtain more of it at bargain prices for its rising economy that remains, in spite of being over-contracted, heavily dependent on Russian gas.[131] Since 2008 these Turkish aims have fueled price and transit disputes with Azerbaijan (intensified in 2008–9 during the brief Turkish-Armenian rapprochement) over future Azerbaijani gas flows to Europe[132] Furthermore, because of Ankara's staunch positions in the gas transit debate with Baku, its otherwise fraternal ally, Azerbaijan, Georgia and Romania suggested the AGRI LNG project, which would exclude Turkey from the Azerbaijani-European transit nexus.[133]

The disputes between Baku and Ankara have not hindered other формс оф cooperation between them, however. One example is the possible strenghtening of Ankara's energy-hub ambitions that would occur if Azerbaijani gas exports to Syria begin via the Turkish pipeline grid.[134] Partly on the strength of the two countries' mutual interests in European gas import diversification (supply from Azerbaijan, transit through Turkey) the Azerbaijani-Turkish gas price and transit disputes were resolved on 25 October 2011 when 15 agreements between Azerbaijan and Turkey were signed in Izmir. The agreements settled the long price disputes between Ankara and Baku and set forth agreed-upon terms for Azerbaijani gas transit to Europe. The agreements also officially committed l 6 billion m^3 of gas annually

[131] Winrow GM (2009) *Problems and Prospects for the "Fourth Corridor": the Positions and Role of Turkey in Gas Transit to Europe*, NG 30 edn. Oxford: Oxford Institute for Energy Studies, 13–19.

[132] Baku tried to bring the 2001 gas price, $120 per 1000/$m^3$, more in line with European netback prices (almost 3 times higher). Abbasov S (2010) Turkey, Azerbaijan Gas Agreement Reached, but Talks to Continue. *EurasiaNet* (7 June) 2010. Source: http://www.eurasianet.org/node/61234. Retrieved: 10 August 2010.

[133] The AGRI would carry Azerbaijani natural gas to a new LNG terminal in Kulevi, Georgia that would transit liquefied gas to Romania. Hungary has also joined the project. See: Négyoldalú közös nyilatkozat az AGRI projekt jövőjéről [Fourlateral Common Declaration on the Future of the AGRI Project]. Source: http://www.kormany.hu/hu/nemzeti-fejlesztesi-miniszterium/klima-es-energiaugyi-allamtitkarsag/hirek/negyoldalu-kozos-nyilatkozat-az-agri-projekt-jovojerol. Retrieved: 22 February 2011.

[134] Azerbaijan to begin gas exports to Syria in 2011: Minister. *Azernews* (30 June 2010). Source: http://www.azernews.az/en/Oil_and_Gas/21812-Azerbaijan_to_begin_gas_exports_to_Syria_in_2011:_minister. Retrieved: 10 April 2011

from the second phase of Shah Deniz for Turkey,[135] an allocation that paved the way for the implementation of at least part of the ambitious European Southern Gas Corridor plans.

5.3. Russia: the key regional power, new export market and market competitor

Russia, by far Azerbaijan's largest and most powerful neighbor, has set the benchmark for Azerbaijani foreign policy since Azerbaijan became effectively independent, in spite of Russia's attempts to maintain a lock on its influence the Southern Caucasus, its practical support of Armenia in the Nagorno-Karabakh conflict, and its intervention into Azerbaijani internal issues during the political turmoil of 1992–93. Russia's influenced has only been strengthened by the fact that it was the key source of Azerbaijani natural gas import between 1985 and 1995 and from 2000 until 2007. Even now, Russian-Azerbaijani relations are still based on two major dimensions: energy issues and Nagorno-Karabakh.[136]

During President Elcibey's pro-Western and pro-Turkish foreign policy line and during the Aliyevs' multi-vectoral foreign policy, Azerbaijan was particularly anxious to maintain its independence from Moscow. Spurred by Gazprom's price hike in early 2007 and encouraged by the discovery and utilization of the Shah Deniz field, Azerbaijan has suspended gas imports from Russia,[137] a move that effectively severed the Azerbaijani energy industry from Moscow's leverage.

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[135] SOCAR's Izmir ceremonies. *SOCAR.az*. Source: http://new.socar.az/socar/en/news-and-media/news-archives/news-archives/2011/10/27. Retrieved: 10 January 2012.

[136] Kjaernet H (2009) The energy dimension of Azerbaijani–Russian relations: Maneuvering for Nagorno-Karabakh. *Russian Analytical Digest* 56 (3 March 3 2009): 2-5.

[137] Although Gazprom's doubling of the export price of gas for inter alia Azerbaijan in 2007 can be explained by market principles (Bowden J (2009)Azerbaijan: From gas importer to exporter. In: Pirani SM (ed.) *Russian and CIS Gas Markets and their Impact on Europe*.Oxford: Oxford Institute for Energy Studies, 224–225), there are indicators that Azerbaijani leaders considered this move "commercial blackmail" (Cohen A (2009) Energy Security in the Caspian Basin. In: Luft G and Korin A (2009) *Energy Security Challenges for the 21st Century*. Santa Barbara: Praeger Security International, 116).

Without question, Russia's energy strategy has been based in the context of political, economic and market considerations[138] in which energy is a tool for strategic manipulation.[139] This has been especially true during Putin's term, when geopolitical and geo-economical considerations have come to the fore. But it has also manifested in the Russian efforts to control Eurasian oil and gas supplies throughout Eurasia. Russia, with its slowly declining gas output and amortizing transit infrastructure, has been eager to acquire Central Asian gas more cheaply in order to cover Europe's growing needs—and to reap European netback prices—by re-exporting it and thereby postponing pricey investments into the development new fields on the Yamal peninsula and the associated transit infrastructure. Russia has also tried to derail U.S.-backed European energy diversification plans because Moscow perceives them as unfriendly moves that threaten Russian control over Eurasian energy supply networks

Considering these tensions and aspirations, it is no wonder that in spite of Russia's own commercial incentive to supply some North Caucasus territories, which can be done more cheaply from Azerbaijan than from Siberia, barely in mid-2008 (barely 18 months afer the suspension of Azerbaijani gas imports from Russia) Russian gas giant Gazprom offered to import Azerbaijani natural gas at "European prices"—a move that would, of course, have decreased the amount of gas available for Azerbaijan's European projects. Having seen the slow implementation of Nabucco and other European projects, in order to retain a market for its own growing production Azerbaijan signed an export contract with Russia in 2009 that increased the amount of exported gas to 3 billion m^3 in 2012 and "more than 3 billion" m^3

[138] Larsson R (2006). *Russia's energy policy: Security dimensions and Russia's reliability as energy supplier.* Stockholm: Swedish Defence Research Agency.

[139] Stulberg A (2007) *Well-Oiled Diplomacy: Strategic Manipulation and Russia's Energy Statecraft in Eurasia*. Albany: State University of New York Press.

after 2013.[140] But Baku also had political reasons to opt for gas export to Russia and to not alienate Moscow: the Russian military intervention in Georgia in 2008, Russia's close relationship with Armenia and Russia's possible role in the solution of the Nagorno-Karabakh conflict.[141]

However, Azerbaijan cannot substitute Russia for a large, reliable, politically non-interfering market like Europe, even though Russia pays "European prices" for Azerbaijani gas. For one thing, Baku cannot be sure that Russia will remain a stable, well-paying market and a reliable transit route. Despite its declining output, Russia has the largest gas reserves in the world and it is obvious that Moscow buys Azerbaijani gas in large part to undermine its European ambitions.

Transit of Azerbaijani gas through Russia to Europe would be problematic for two other reasons as well. First, beyond Russian's attempts to maintain its leverage in the South Caucasus, its Eurasian energy strategy and Moscow's record in utilizing its transit positions against Central Asian producers force Baku to stay aware of the dangers of dependence on Russian transit. For these reasons, dependence on Russian transit is essentially against Azerbaijan's strategy of multiple export, pipeline-based, multi-vectoral foreign policy. Second, the transit cost of gas trade through Russia would be too high for European buyers. Baku would certainly not turn a profit, nor does it want to swallow that cost.[142] Essentially,

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[140] SOCAR and Gazprom sign addendum to natural gas purchase and sale contract. *SOCAR.az*. Source: http://new.socar.az/socar/en/news-and-media/news-archives/news-archives/id/4192. Retrieved: 2 February 2012.

[141] Valiyev A (2010) Finlandization or Strategy of keeping the Balance? Azerbaijan's Foreign Policy since the Russian-Georgian War. *PONARS Eurasia Policy Memo* no. 112.

[142] Добронравин НА (2008) Нефть, газ и «транспортное проклятие»: Казахстан, Туркменистан, Азербайджан. In: Добронравин НА and Маграния О (eds.) *Нефть Газ, Модернизация Общества*, (eds.). Saint Petersburg: Saint Petersburg State University Advanced School of Economics 444–445.

Russian opposition to European gas import diversification efforts in the Caspian has made Baku and Moscow into competitors for the European market.

5.4. Iran: the controversial neighbor and new export market

Iran's strained relationship with Azerbaijan since it became independent from Russia extends the two countries' relations in the natural gas trade. Tehran, suspicious of Azerbaijan's independence and Baku's stance towards the Azeri minority in Iran in the early 1990s, has maintained a good relationship with Armenia. Iran has also been opposed to Azerbaijani offshore explorations in the Caspian Sea, citing its unresolved status and sometimes resorting to military threat to emphasize this message.[143] For its part, Azerbaijani leadership has been suspicious of Iran's relations with religious groups in Azerbaijan. Baku has good reason to maintain positive relations with Tehran, however: since 2006 the Nakhichevan exclave has been supplied by Azerbaijani natural gas through Iranian territory.

Nonetheless, Iran is deeply interested in Azerbaijani natural gas resources. Despite sitting on the second largest natural gas reserves in the world, Iran's growing production can hardly keep up with its large consumption. Lacking foreign investment, Iran's domestic investment in its gas pipeline infrastructure is insufficient because of its high subsidization of its enormous domestic consumption and because the infrastructure based on domestic resources doesn't cover all parts of the country.[144] Therefore, Iran has been eager to buy more Azerbaijani gas for "European prices" to meet its domestic needs. In January 2011 Iran and Azerbaijan contracted for an annual export of yearly 1 billion m^3 of natural gas for five

[143] Cornell SE (2011) *Azerbaijan Since Independence*. New York: M.E. Sharpe, 301–317.

[144] Shaffer B (2009) *Energy politics*. Philadelphia: University of Pennsylvania Press, 149–154.

years.[145] Although Iran has not yet purchased natural gas from Azerbaijan, the contract is viable and Azerbaijan has offered to supply gas for Iran[146] despite the tense relationship between the two countries.

Beyond some common strategic and commercial interests, Iran could not be a long-term, big market for Azerbaijan energy export even if it did not have its own huge reserves and energy export ambitions. Not only are Azerbaijan and Iran potential competitors, the implementation of Azerbaijan's European import diversification plans in the Caspian is intended to involve Azerbaijani sources—not Iranian ones.

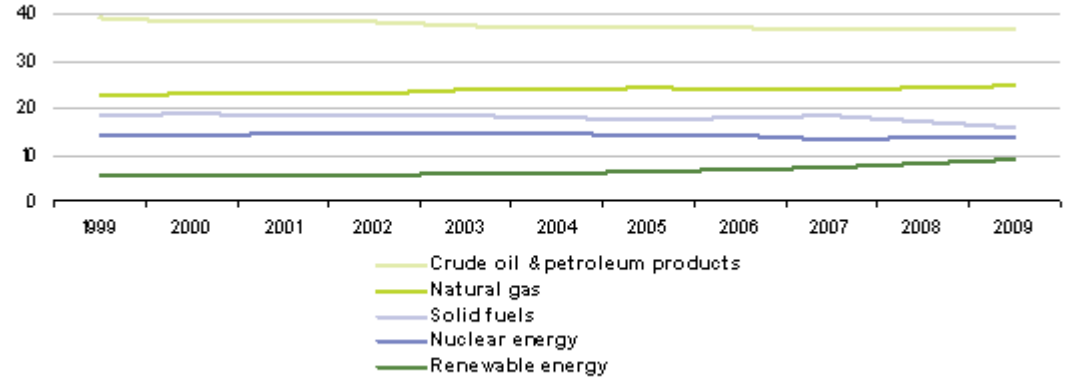
5.5. The European Union: the most desirable future market

The European Union and Azerbaijan have mutual interests in the import of Caspian energy resources from the post-Soviet Caspian region. Countries of the European Union, most of which are lacking sufficient energy sources, have substantial demands for oil and natural gas. Due to the production decline of indigenous sources (especially in the United Kingdom and the Netherlands), the EU is expected to become more and more reliant on import. Although the EU has formulated the intention of establishing a cleaner and more energy- efficient economy,[147] its dependence on hydrocarbons remains high, especially because of some countries's mistrust of nuclear energy (see Figure 10).

[145] *AzNews.org* (2011) Азербайджан поставит в этом году в Иран 1 млрд. кубометров газа. [Azerbaijan delivers 1 bcm gas to Iran this year] Source: http://aznewsorg.livejournal.com/3439458.html. Retrieved: 23 January 2011.

[146] *Center for Economic and Social Development (10 November 2011)* SOCAR politicizes gas export issues**.** *Source:* http://cesd.az/new/2011/11/cesd-socar-politicize-gas-export-issues/. Retrieved: 20 February 2012.

[147] Rosner K (2009) The European Union. On Energy, Disunity. In: Luft, G and Korin (2009) *Energy Security Challenges for the 21st Century*. Santa Barbara: Praeger Security International, 161–162.



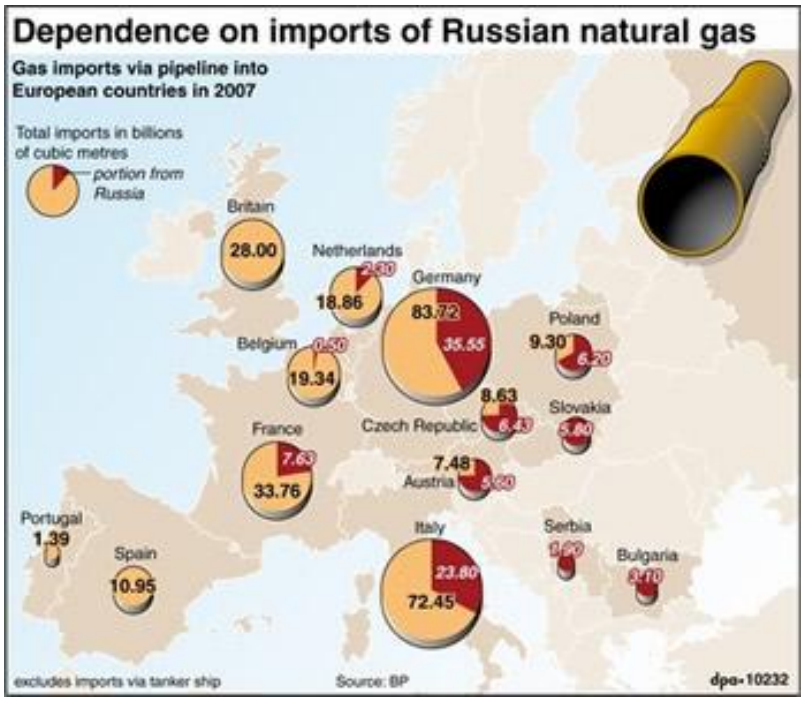
Source: Eurostat (online data codes: ten00086, nrg_102a, nrg_103a, nrg_101a, nrg_104a and nrg_1071a)

10. Gross inland energy consumption in the EU 27, 1999-2009
Source: Eurostat

Russia has been a key supplier of both oil and natural gas, especially to East and Central Europe (see Figure 11). However, since the gas crises of 2006 and 2009 between Russia and Ukraine concern has risen within the EU about energy security and especially about Russia's role as a reliable supplier.[148] Although the EU has been in favor of the diversification of natural gas imports since the gas crisis, the issue of efficient European plans for the diversification of energy, especially natural gas imports, has been curtailed by the lack of a blanket energy policy and the diversity of the member states' energy industries, energy sources and interests. The U.S. has also backed European natural gas import diversification plans because they dovetail with Washington's strategy of strengthening the energy security of Europe and helping the Caspian post-Soviet producers reach world markets.[149]

[148] The Russian-Ukrainian gas crises were an unintended blow to Russia's image as a reliable supplier. The interdependence of Russia and the EU is apparent as Europe has been Russia's key source of hard currency revenues since the establishment of oil and gas trade between the Soviet Union and Europe in the 1960s–1970s. Since 1991 Russia has utilized its position as a transit state for natural gas from post-Soviet countries to Europe, which has effectively made it a re-seller of Central Asian natural gas to Europe, while also subsidizing its internal market and retaining the benefits of European "netback" prices. Russian profits from European netback prices have long resented by other post-Soviet producers that have been forced to sell their gas to Russia for a fraction of the prices European markets pay for the same Russian (re-exported Caspian) gas.

[149] Morningstar R (8 June 2011). Presentation at the 18th Caspian Oil and Gas Conference, Baku.



112. European dependence on imports of Russian natural gas in 2007
Source: http://www.dpa.de/Infographics-Slideshow.482.0.html

Even though the EU and Azerbaijan have a much broader common agenda and better mutual relations, as shown by the Partnership and Cooperation Agreement (part of the framework of the European Neighborhood Policy signed between Baku and Brussels in 1999), since 2006 energy has been the most salient Euroepan interest in Azerbaijan. Since the Russian-Ukrainian gas crisis of 2006, Brussels has sought closer relations with the post-Soviet Caspian region and better cooperation over energy trade. The Memorandum of Understanding on a Strategic Partnership between the European Union and the Republic of Azerbaijan in the Field of Energy (MoU), signed by the EU and Azerbaijan in 2006, implicitly reflects European fears that began with the Russian-Ukrainian gas crisis and the launch of gas production from the Shah Deniz field. The MoU addresses several mutual

security interests in the Southern Caucasus as well, especially regarding the security that an energy trade infrastructure may provide and may need.[150]

Project	Consortium	Countries of transit	Capacity	Cost	Completion	Sources of gas	Sources of financing
Nabucco	OMV of Austria, MOL of Hungary, RWE of Germany, Bulgargaz of Bulgaria, Transgaz of Romania and Botas of Turkey	Turkey, Bulgaria, Romania, Hungary	38 bcm/year upon completion	The total investment of Nabucco is estimated to exceed EUR 7.9 billion	Construction is expected to start in 2012, and the first gas to flow the end of 2015	Azerbaijan and Iraq	Private and public
South Stream	Gazprom, ENI of Italy, inter-governmental agreements signed with Bulgaria, Serbia, Greece, Hungary, Slovenia.	Bulgaria, Greece, Italy, Serbia, (possibly Romania), Hungary, Slovenia	63 bcm/year upon completion	From 19 to 24 billion euros according to estimations	2015	Russia. Gazprom could also sell gas it would buy in the Caucasus	Gazprom wants a EU label to the project to attract investors
ITGI	Edison of Italy, DEPA of Greece	Turkey, Greece, Bulgaria,	10 bcm/year in 2015	Not disclosed	2015	Azerbaijan	Private and public
TAP	EGL, Statoil, E.ON Ruhrgas	Greece, Albania, Italy	10 bcm/year to 20 bcm/year	1.5 billion euros	2016	Azerbaijan	Project finance
AGRI	State-own energy companies of Azerbaijan, Georgia, Romania	Georgia, Romania	One, five or eight bcm/year according to variants	Not known, feasibility study not yet realised	?	Azerbaijan	Mostly public
White Stream	Consortium members not disclosed	Georgia, Romania	8 bcm/year	Not known	?	Azerbaijan	?

32. European plans for the diversification of natural gas import, 2011
Source: Euractiv

Since the early 2000s various pipeline plans by European energy companies have appeared to utilize Shah Deniz and Central Asian gas for Europe's growing consumption; since 2006 especially, Azerbaijan has been considered the keystone of European energy import diversification efforts (i.e., the European Southern Gas Corridor). The corridor includes almost all of the pipeline projects (Figure 12) that would connect the Caspian region

[150] Memorandum of Understanding on a Strategic Partnership between the European Union and the Republic of Azerbaijan in the Field of Energy (7 November 2006). Source: http://ec.europa.eu/dgs/energy_transport/international/regional/caucasus_central_asia/memorandum/doc/mou_azerbaijan_en.pdf. Retrieved: 15 January 2012.

with Europe, from the EU-backed Nabucco natural gas pipeline project to the other European projects that would diversify natural gas import, namely the Interconnector Turkey-Greece-Italy pipeline (ITGI), the Trans-Adriatic Pipeline (TAP), the White Stream project and the Azerbaijan-Georgia-Romania Interconnector (AGRI).

Despite the Russian-Ukrainian gas crisis of 2009 and backing by the United States, these European plans (including the Nabucco, which has been heavily promoted by the European Commission) have not developed very much. The annual 31 billion m^3 capacity of the Nabucco has taken into account the need to transmit Central Asian resources through a Trans-Caspian gas pipeline. The Central Asian supply, however, has been uncertain because of the Caspian Sea boundary debates and the bad investment climate in Turkmenistan. The world financial crisis has also raised construction costs. Without Central Asian resources, only one-third of the Nabucco could be filled with the 10 billion m^3 gas Azerbaijan has offered, a lack that would the project unprofitable for investors despite political backing from both Brussels and Washington.

However, Baku continues to make the European market a clear priority, as shown by the Joint Declaration on the Establishment of the Southern Gas Corridor, signed on 13 January 2011 between the EU and Azerbaijan, and the 15 agreements signed between Azerbaijan and Turkey on 25 October 2011 in Izmir that resolved the price dispute and transit debate between Baku and Ankara and opened the way for smaller-scale pipelines such as the ITGI and TAP. Moreover, on 26 December 2011 Azerbaijan and Turkey agreed on the construction of the Trans-Anatolian pipeline, which would provide sufficient capacity for Azerbaijani natural gas transit through Turkey to Europe—a strong implication that Azerbaijan is ready to invest substantial monies in order to connect its current gas export

pipeline grid with European ones.[151] On 20 February 20 the Shah Deniz Consortium (a group comprised of the most influential players in SOCAR and BP) opted for the TAP to carry natural gas from Shah Deniz to Europe.

Neither the TAP nor the Nabucco would mean significant diversification of natural gas imports for the European Union. However, the implementation of energy import from Azerbaijan would be an important step toward the establishment of broader gas import from the Caspian to cover Europe's growing import needs. Nor have decision makers and investors seem to have completely abandoned the idea of larger volumes of Azerbaijani or Caspian gas flows through a larger-scale pipeline. For example, the South-East Europe *Pipeline (SEEP)* project proposed by the BP, the reconfiguration of Nabucco into "West-Nabucco" and the Turkish-Azerbaijani Trans-Anatolian pipeline all promise larger capacities of gas flows from the Caspian to the European Union. Despite its current, relatively small volume, Azerbaijani gas may strengthen the energy security in some regions. This would be so particularly in Central Europe where, harsher winters[152] may quickly deplete the resources from Russia upon which they now depend.

For Azerbaijan, growing European dependence means secure demand. The importance of a stable, well-paying partner like the EU also is indicated by the efforts of Caspian countries to establish trade relations with the EU that do not include Russian transit, in spite of Moscow's attempts to use its current pipeline monopoly to keep prices low and maintain its regional influence. Thanks to its location west of the Caspian Sea, Azerbaijan is the first

[151] Azerbaijan's share may be as much as 80 percent of the 5 billion USD project. News.az (December 27 2011) Volume of gas flowing through Trans Anadolu would be increased.. Source: http://www.news.az/articles/turkey/51726. Retrieved: 28 December 2011.

[152] Freezing Europe hit by Russian gas shortage. *BBC*, 3 February 2012. Source: http://www.bbc.co.uk/news/world-europe-16883560. Retrieved: 3 February 2012.

non-Russian post-Soviet gas exporter country to have even the opportunity of direct export pipeline connections with Europe. As previously mentioned, the EU is also considered to be a non-interfering partner politically. This largely neutral stance is also a distinct advantage compared to Azerbaijan's current export markets (except Georgia), which to different degrees used their leverage to influence Azerbaijani policy-making in the 1990s.

In addition, the establishment of European pipelines would make future conflicts in the Southern Caucausu such as an escalation of Nagorno-Karabakh conflict between Armenia and Azerbaijan more difficult, raising the risks of challenging the status quo. Given the strategic nature[153] of natural gas pipelines that connect producers, transit states and markets, the fact that such pipelines require preliminary investment and the fact that it is in participants' best interest to maintain them, those looking to start or continue a war would naturally be more cautious about attacking infrastructures. Such attacks would not only damage the strategic interests of the aggressors but would also harm the markets. A possible shutdown of European gas pipelines due to armed conflict would "bring" the European Union directly into the region.[154]

[153] Security concerns are legitimate, as the BTC pipeline was shut down 2 days before the Georgian war in 2008 due to the activity of Kurdish separatists. The BTE gas pipeline was shut down after the Georgian war due to security concerns, but no damage was done on it. BP Halts BTC Oil Loading, Pipe Shutdown to Last Weeks. *Bloomberg*, August 7, 2008. http://www.bloomberg.com/apps/news?pid=newsarchive&refer=energy&sid=ah7sKNYnEEzY. Retrieved: 11 November 2011.

[154] Even Russia did not play out the card of destroying the Georgian energy transit infrastructure to undermine the sense of security of pipelines that run though the country, giving itself a blow as a reliable partner for Europe. While "normal" instruments, peaceful practices are legitimate means to promote one's energy interests against, say, European energy import diversification efforts, a "hard" raw military strike would be an open aggression against one's strategic interests. However, a shutdown in a war can occur as collateral damages. Sokov, N. 2009, *The South Caucasus Corridor after the Russian-Georgian War*. *PONARS Eurasia Policy Memo*, No 49. January 2009.

5.6. Azerbaijan's alternative future market options: Syria, Ukraine

Despite the difficulties around the implementation of the European gas pipelines, Baku has maintained a multi-vectoral approach to its natural gas export policy—albeit with particular emphasis on the European vector. This emphasis also means, however, that Azerbaijan is open at least in theory to every option of export diversification as its negotiations with various non-European markets show. These negotiations have taken place for two reasons. First, taking other projects into consideration allows them to raising the stakes for partners wishing to participate in extant projects. Second, because gas (unlike oil) cannot be stored, Azerbaijan must sell its natural gas surplus but cannot take the implementation of some current projects for granted.

Since 2009 two major Azerbaijani possible alternative gas export negotiations have been seriously considered but have led to different levels of implementation: Syria[155] and Ukraine.[156] Both countries have been looking for natural gas to provide stabile energy sources for their economies and both have turned to Azerbaijan as a possible source.

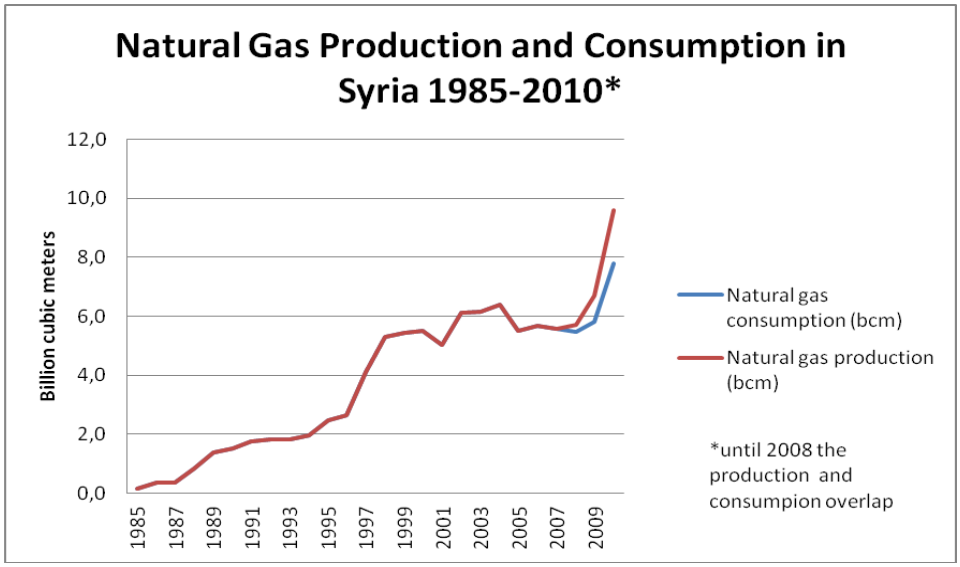
The Azerbaijani export of natural gas to Syria, the first alternative non-European project to considered, also seems as if it will be the first to be implemented. Due to its volatile and limited levels of domestic production (see Figure 13), Syria has been importing natural gas from Egypt since the completion of the Arab Gas Pipeline (AGP)[157] in 2009 and has been looking at additional sources of import to bridge the gap between its domestic consumption and its own production. Moreover, Syria's plans to transform itself into a regional energy hub

[155] Баку планирует поставлять газ в Сирию с 12 года. *Reuters Россия и страны СНГ*, 27 December 2010. Source: http://ru.reuters.com/article/businessNews/idRURXE6BQ1DL20101227. Retrieved: 10 January 2011

[156] Украина и Азербайджан подписали документы о поставках сжиженного газа. *РИАНовости Украина*, 28 January 2011. Source: http://ua.rian.ru/economy/20110128/78636447.html. Retrieved: 28 January 2011.

[157] The Arab Gas Pipeline connects Egypt, Jordan, Syria and Lebanon.

(the "Four Seas Strategy") has led to its participation in an energy network that is meant to link the Persian Gulf, Mediterranean Sea, Caspian Sea and Black Sea.[158] Cooperation among the Azerbaijani, Turkish and Syrian governments on the establishment of Azerbaijani export through Turkey to Syria began in 2009.



43. Natural Gas Production and Consumption in Syria 1985-2010
Source of Data: BP Statistical Review of World Energy Historical Data.

The first agreement between Azerbaijan and Syria, for the export of 1 billion m^3/year of Azerbaijani natural gas, was signed in July 2009 during Syrian President Bashar al-Assad's visit to Baku.[159] Also in 2009, Syria and Turkey agreed to connect the Syrian and Turkish natural gas pipeline grids with a pipeline between Aleppo and Kilis by continuing the construction of the Arab Gas Pipeline to Turkey,. Although the pipeline was planned to

[158] Syria aims to become an economic hub among the four seas. *The Middle East Reporter*, 9 August 2009. Source: http://www.thefreelibrary.com/Syria+aims+to+become+an+economic+hub+among+four+seas.-a0207746440. Retrieved: 10 April 2011.

[159] Азербайджан согласился продавать Сирии до 1 млрд. кубометров газа в год. *Navigator.az*, 10 July 2009. Source: http://www.navigator.az/news/2/18436.html. Retrieved: 10 April 2011.

forward Egyptian natural gas to Turkey,[160] it be used to carry Azerbaijani natural gas to Syria through the existing Baku-Tbilisi-Erzurum (BTE) pipeline and the Turkish gas pipeline network.[161] The construction of the Syrian portion of the Aleppo-Kilis pipeline has begun and is expected to be finished in 2012; the entire pipeline is expected to be completed in 2012.[162]

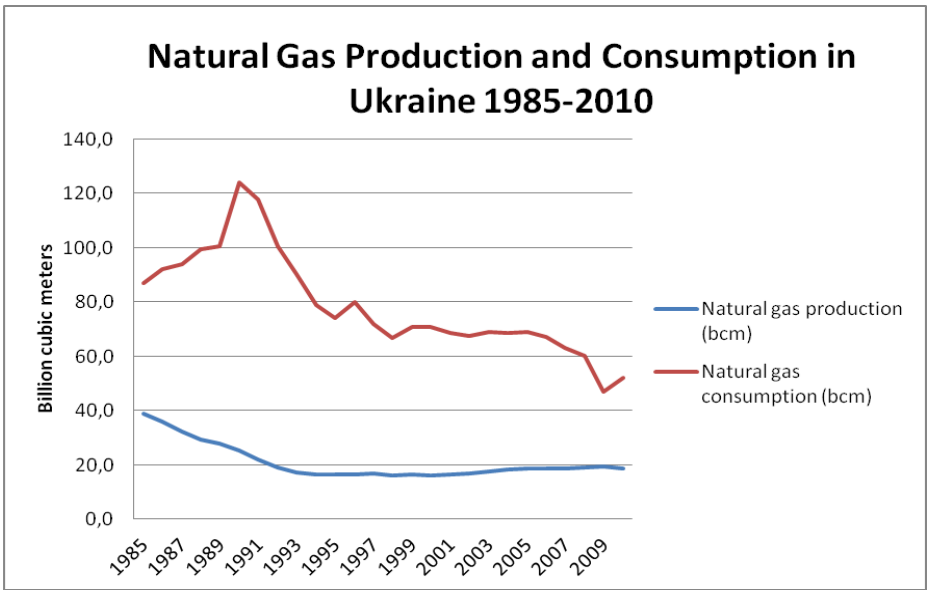
Concerning Azerbaijani gas export to Ukraine, large demand can be taken for granted (see Figure 14). Since Soviet times the Ukrainian energy industry has been based on Ukrainian natural gas production that was large but has since declined. Paradoxically, Ukrainian industrial development became more natural-gas-intensive as reserves were depleted, making Ukraine heavily and increasingly dependent on Russian natural gas import.[163]

[160] Turkey and Syria Sign Gas Pipeline Protocol, Sabah Reports. *Bloomberg*, 21 August 2009. Source: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ag6M5g3hQG2c. Retrieved: 6 April 2011.

[161] Azerbaijan to begin gas exports to Syria in 2011: Minister. *Azernews*, 30 June 2010. Source: http://www.azernews.az/en/Oil_and_Gas/21812-Azerbaijan_to_begin_gas_exports_to_Syria_in_2011:_minister. Retrieved: 10 April 2011.

[162] Energy Ministry: Construction of the Turkish section of Kilis-Aleppo pipeline to be completed in 2012. *Trend.az*, 19 January 2011. Source: http://pda.trend.az/en/1814691.html. Retrieved: 5 April 2011.

[163] Pirani, S.M. 2009, "Ukraine: Gas Dependent State" in *Russian and CIS Gas Markets and their Impact on Europe*, ed. S.M. Pirani, Oxford Institute for Energy Stduies, Oxford. pp 95-97.



54. Natural Gas Production and Consumption in Ukraine 1985-2010
Source of Data: BP Statistical Review of World Energy Historical Data.

Since the two natural gas crises with Russia in 2006 and 2009, Ukraine has been considering the import of natural gas from the Caspian region, a plan that would both allow it to exclude Russian transport networks and ease Kiev's dependence on Russian natural gas. The first plan to carry natural gas from Azerbaijan to Ukraine, the White Stream pipeline project,[164] is still in the blueprint stage. The first step to Ukrainian gas import diversification that was both concrete and official took placde when the Intergovernmental Memorandum between Ukraine and Azerbaijan was signed on 8 January 2011 for delivery of an annual supply of Azerbaijani liquefied natural gas (LNG) beginning in 2015. Project costs for the construction of an LNG terminal with the annual capacity of 10 billion m^3 on the Ukrainian Black Sea coast are estimated at 2.5 billion USD.[165]

Various statements have been made about the possible volume of Ukrainian natural gas import from Azerbaijan. The most recent one implies that Ukraine is looking to receive 2

[164] White Stream Project – The route. See: http://www.gueu-whitestream.com/main.php?id=18&lang=eng

[165] See *РИАНовости Украина*, 28 January 2011.

billion m^3 of natural gas annually after 2014 and 5 billion m^3 after 2015.[166] In order to implement the onshore phase of the Azerbaijani-Ukrainian LNG trade, an LNG compressing terminal and a pipeline of sufficient capacity will have to be built from Azerbaijan to the Georgian seashore, roughly parallel to the oil and natural gas pipelines that are already there.

The Syrian and Ukrainian market options pose risks for Azerbaijan. Although the Syrian and Turkish pipeline grids have been successfully connected in anticipation of the Azerbaijani-Syrian gas trade, Syria is not only continuing to experience internal turbulence that began with the Arab Spring and may reduce infrastructure security, due to its volatile gas extraction and small market size it cannot be considered as a market with stable demand. Despite its large demand, Ukraine has been in a near-constant state of economic cris since declaring its independence; in fact, a major reason for Kiev's sometimes-tense relations with Moscow is Ukraine's inability to pay "European" prices for Russian natural gas.

5.7. Azerbaijan as a possible transit country

In order to evaluate the importance of natural gas export within Azerbaijan's foreign policy, the issue of Azerbaijan as a transit country must be addressed. European plans to import natural gas from the Caspian are not only based upon Azerbaijani supply but also count on Azerbaijan as a transit country for Central Asian (especially Turkmen) natural gas to the West. Azerbaijan's position as a key transit country for future Western-Central Asian energy trade has been considered a strategic asset by not only Azerbaijani leaders but also by academics such as Zbigniew Brzezinski.

[166] Украина рассчитывает получить 2 млрд кубометров азербайджанского газа. *РИАНовости Украина*, 31 January 2011. http://rian.com.ua/economy/20110131/78638999.html. Retrieved: 1 February 2011.

Brzezinski (2009) cited Azerbaijan as a pivotal country in his book *The Grand Chessboard*,[167] but Azerbaijani leaders were already keen to utilize the country's location. Bordered by three regional powers (Russia to the north, Iran to the south and Turkey to the west), Azerbaijan is the only country that can provide transport routes for Central Asian natural gas to the West without passing through Russia or Iran. Therefore, U.S.-backed plans for pipelines to carry natural gas from Central Asia (especially from Turkmenistan) were considered the most valuable by Azerbaijani leadership in the 1990s and the Trans-Caspian pipeline (TCP), together with the BTC oil pipeline, was thought of as a branch of the "Eurasian Energy Corridor."[168]

However, Azerbaijan's stance as a prospective transit country changed with the discovery of the Shah Deniz gas field in 1999. Since that time Baku has promoted itself not only as a transit state but also as a supplier and, moreover, has demanded that almost half its share of the gas from Shah Deniz be exported in the 30 billion m^3 annual capacity pipeline. This demand has brought the TCP to a standstill and has worsenend the traditionally poor Azerbaijani-Turkmen relationship.[169] Although the TCP pipeline plans went were briefly revived after the the Nabucco project began in 2002, one of the most serious barriers to the implementation of Nabucco has been poor Turkmen-Azerbaijani relations and especially disputes over the borders of the Caspian Sea.

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[167] Brzezinski, Z., *The grand chessboard : American primacy and its geostrategic imperatives*, BasicBooks, New York. pp 46-47.

[168] Aliriza, B. 2000, "The Eurasian Energy Corridor: Turning into the Cul-de-Sac? ", *CSIS Caspian Energy Update*, www.csis.org/media/csis/pubs/ceu000225.pdf. Retrieved: 2 December 2008.

[169] Stern, J.P. 2005, *The Future of Russian Gas and Gazprom.* Oxford University Press, Oxford. p 75.

One of the most heated issues in the debate about the status of the Caspian Sea has been the borders and ownership of the Azeri, Chirag and Kyapaz (in Turkmen: Omar, Osman and Serdar) oil fields that lie between Azerbaijan and Turkmenistan. Since Azerbaijani production of the Azeri and Chirag fields began in the mid-1990s Azerbaijani-Turkmen relations have cooled and the affiliation of the area has been hotly debated. Although relations between Baku and Ashgabat have generally improved since 2007, tensions about the border issue have persisted.[170] The European Union's promotion of negotiations in order to reach an agreement between the two countries that would function as a basis for the implementation of any Trans-Caspian pipeline have failed to bear fruit.[171] In addition, the status of future Turkmen gas supply to Europe has remained uncertain—not only because of the Caspian Sea boundary debates but also because of the bad investment climate in Turkmenistan and the effect of the world financial crisis that since 2009 has raised commodity prices and the costs of pipeline construction in general.[172]

Despite the long-desired strategic prize of the establishment of Central Asian natural gas that would turn Azerbaijan into a key transit country (now a blurred possibility), as Pflüger (2012) noted,[173] even if this prize is somehow obtained it may conflict with Azerbaijan's commercial interest in exporting the gas output of Umid and Absheron (now

[170] Valiyev, A. 2009, Azerbaijan and Turkmenistan's Dispute over the Caspian Sea. Will It Impede the Nabucco Project?. *PONARS Eurasia Policy Memo* No. 87.

[171] Oettinger G (8 June 2011). Presentation at the 18th Caspian Oil and Gas Conference, Baku.

[172] As a result of growing commodity prices, the cost estimates for the Nabucco project grew twofold, to 22 billion dollars. See: Nabucco Pipeline May Cost $19 Billion, BP Says, Guardian Reports. *Bloomberg*, February 22, 2011. http://www.bloomberg.com/news/2011-02-22/nabucco-pipeline-may-cost-19-billion-bp-says-guardian-reports.html. Retrieved: 26 February 2012.

[173] Pflüger, F. 2012, Who will win the first leg of the pipeline race in South East Europe? The Southern Gas Corridor: Reaching the Home Stretch. *European Energy Review*, January 12, 2012. http://www.europeanenergyreview.eu/site/pagina.php?id_mailing=244&toegang=9188905e74c28e489b44e954ec0b9bca&id=3455. Retrieved: 14 January 2012.

predicted to be available in early 2020s). The establishment of a Trans-Caspian pipeline, however desirable, may pit Azerbaijani strategic interests against its commercial interests in exporting natural gas. Baku and Ashghabat have to agree on their respective shares of pipeline capacity for Azerbaijani and Turkmen gas. Although they are neighbors with common interests, Turkmenistan and Azerbaijan are also market competitors.

Having considered Azerbaijan's foreign policy relations with its current and future natural gas export markets, we can see that Azerbaijan's energy-based multi-vectoral foreign policy basically means foreign economic policy as strategic and commercial interests are strongly intertwined. It is also easy to see that natural gas already plays or may play an important aspect in Baku's foreign relations.

CONCLUSION

The present thesis has addressed the issues salient to the interrelations of natural gas export and Azerbaijani foreign policy. Despite the fact that natural gas is still considered of minor significance for Azerbaijan compared to oil, I have hypothesized that its geopolitical and commercial implications render it of much higher importance for Baku's foreign policy making than is now generally believed. In conclusion I would like to discuss whether the model of oil export diversification in Azerbaijan's foreign policy may be applied to Azerbaijan's natural gas export strategy.

Natural gas has attracted major attention within the discussion of the future of energy production, not only because it is a cleaner source of energy than oil and coal but also because of its widely dispersed global location. Thanks to the prospects of wider utilization of unconventional gas (despite environmental concerns about hydraulic fracturing technology), natural gas is a relatively flexible, abundant resource for the growing international energy demand. The transit of natural gas, however, poses numerous challenges. Despite the recent growth in liquefied natural gas trade, transit of gas in large volumes is viable mostly through pipelines, the buiding and maintenance of which touch upon numerous political and security issues. This is especially so when the exporter country is located far from the markets or is landlocked, which requires the cooperation of transit countries.

Azerbaijan, a landlocked post-Soviet energy exporter country, has been determined to utilize energy exports in its foreign policy. When it became independent in 1991 Baku was

still in many ways dependent on Russia, the country from which it officially declared independence, the country that supported Armenia in the 1988–94 conflict over Nagorno-Karabakh, the country that controlled the available transit infrastructure for Azerbaijani oil export and the country that had been the source of Azerbaijani natural gas import.

Iran was also a source of concern, given Tehran's fears of Azerbaijani irredentism and good relations with Armenia. Since 1992 successive Azerbaijani governments have utilized oil and natural gas resources in order to strengthen the country's independence and to stabilize its internal political and economic order. Since Heydar Aliyev's rise to power in 1993 Azerbaijan has followed a multi-vectoral foreign policy approach. A balanced stance toward all regional partners, in order to strengthen Azerbaijan's independence, and the enlargement of its production and export of oil have been the key instruments of this policy.

The so-called "Contract of the Century" in 1994 began the multi-vectoral approach because it opened up the large Azeri-Chirag-Guneshli fields for foreign (mostly Western) investors who brought in not only new technology and capital but also the interests backing governments. At the same time Russia (or part of the elite) was placated with participation in Lukoil.

Since the mid-1990s Azerbaijan has worked with Turkey, Georgia and the United States to construct export pipeline projects to carry Azerbaijani oil separately from the Russian and Iranian pipeline infrastructures. Thus far, the 1999 opening of the Baku-Tbilisi-Supsa oil pipeline and, more important, the 2006 opening Baku-Tbilisi-Ceyhan oil pipeline have been the key indicators of the success of this policy. The growing number of investments and PSAs and the implementation of transit routes have led to a surge in Azerbaijani oil production and to a windfall of oil revenues that has stabilized Azerbaijan's independence as well as its internal economic and political order. However, the oil windfall

will probably be temporary because the main oil wells of ACG are expected to peak and then and decline in this decade.

As a result of the discovery in 1999 of the large Shah Deniz natural gas field under the PSA operated by BP and Statoil, and of its production (launched in 2006), Azerbaijan has managed to become self-sufficient in natural gas. Thanks to the commission of the Baku-Tbilisi-Erzurum (BTE) gas pipeline that was constructed parallel to the BTC in early 2007, Azerbaijan has not only suspended natural gas imports from Russia and become completely independent of Russian hydrocarbon supplies, but has also begun to export natural gas to Georgia and Turkey. Since the Russian-Ukrainian gas crisis of 2006, Azerbaijan has been considered by the European Union to be the keystone of its natural gas import diversification efforts in the Caspian region, commonly called the European Southern Gas Corridor. These European plans mean not only penetration of a politically non-interfering, well-paying market with reliable, large demand but also the possibility of becoming a transit state for Central Asian natural gas. As this thesis has shown, natural gas export and its diversification can be used for foreign policy goals in much the same ways that oil has been.

The overlapping nature of energy policy and foreign policy making, as well as between commercial and strategic interests reveals the fact that energy export-related foreign policy implies not only strategic interests (the location of pipelines and pipeline routes), but also the realizable energy revenues are important both from point of view of foreign policy and internal policy considerations. Given the overcentralized nature of the Azerbaijani political system, foreign policy decisions lie with the president of Azerbaijan whereas energy policy decisions are made by the president with, on the one hand, the elite groups interested in energy business, and on the other hand by foreign investors that operate energy production and transit infrastructure, most notably BP. Azerbaijan's economy and current political order

are both heavily dependent on energy revenues, especially from oil that supplies the overwhelming majority of export revenues. Natural gas, by contrast, is expected to have an important share of future revenues should export to Europe and other markets be successfully established. Increasing natural gas revenues may even mitigate losses from the expected plateau and decline of oil revenues due to the expected plateau and decline of oil production. Foreign policy is directed to the security of energy export and maximization of revenues, while enregy export policy serves Baku's multi-vectoral foreign policy.

Baku considers Europe to be its main future market. The establishment of natural gas pipeline trade with Europe is strategically important for many reasons. Europe is a well-paying market with substantial demand that is also politically non-interfering. Trade with Europe implies strategically not only the appearance of an important extra-regional partner in the Southern Caucasus through direct pipeline infrastructure, but also the possibility of turning Azerbaijan into a transit country of key importance. Due to the slow implementation of the European pipeline plans, however, Azerbaijan has broadened its multi-vectoral gas export policy. Baku has been compelled to export natural gas to Russia and Iran through existing pipelines and also to begin to look for other markets such as Syria, Ukraine and even Jordan. Europe remains the most desired market, however, because of its reliability of demand and the implications of high revenues, reliable payments and other strategic implications cannot be provided by any other current or possible future market. Europe would be the most desirable market for Azerbaijan's future natural gas export even if the Trans-Caspian pipeline option and the transit of Central Asian natural gas through Azerbaijan were in operation instead of still in the blueprint stage.

This thesis has also shown the clear interrelations Azerbaijan's commercial and strategic interests in terms of gas exports. Azerbaijan has both strategic and commercial

interests in the establishment of natural gas export to Europe: strategic benefits will be based on the direct pipeline infrastructure and the buildup of common strategic energy trade interests with a politically non-interfering partner; commercial benefits will accrue from a well-paying, large market with substantal gas demand. Azerbaijan may continue to follow a multi-vectoral foreign policy based on a multiple pipeline policy for both oil and gas, but given the inherent dependence of the natural gas trade on pipelines that must include cooperation with transit countries and other security implications, Europe will be the weighted vector in Azerbaijan's multi-vectoralism.

Despite the foreign policy benefits and future mitigation effect on the decline of oil revenues that an enlarged natural gas trade will bring, Azerbaijan's growing natural gas export and natural gas revenues cannot entirely remedy the country's structural problems. The economic overreliance on energy revenues is not a healthy state; nor is it sustainable given the underdevelopment of the non-energy sector. The Azerbaijani leadership may find a good way to utilize energy revenues for the transformation of the economy into one that is less dependent on the energy sector. If this trajectory is to be followed, however, it will require the enhancement of good governance, the implementation of efficient technologies and the development of the countryside at least as actively and thoroughly as has been promised in official statements.

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